

**THE IMPACT OF NON-AUDIT SERVICES AND AUDIT PROCESS
STANDARDISATION ON INDEPENDENT AUDIT JUDGEMENT
AND FRAUD RECOGNITION**

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*Mojej Mamie
w podziękowaniu za wszystko*

DECLARATION

This thesis has been composed by the candidate and is the result of the candidate's own investigation. The thesis does not include work submitted for any other degree or qualifications.

Signed..

Katarzyna Kosmala MacLulich

Date.....*23 May 2000*.....

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ABSTRACT

The study addresses issues of audit independence, in particular behavioural and ethical aspects of individual judgement and decision-making in external auditing. The study examines how the auditor's sensitivity to the possibility of fraud, to management representations, and to management services opportunities impacts upon individual audit judgement embedded in a structured audit environment. A phenomenon of management services opportunism is perceived as a form of power exertion by the client over the auditor's judgement and his/her recognition of material fraud. Further, auditing is perceived as hermeneutic practice, that is, the auditor on the job strives to understand and interpret evidence of client's operations embedded in the wider context of social institutions and structural conditions. By doing so, he/she produces assurance to the public that these interpretations are trustworthy. This relates to the notion of operational independence (Power, 1997), that is, the auditor's freedom and capacity to understand and interpret the 'economic text' narrated in the client's financial statements. However, the profession and consequently audit firms, propagate a symbol for the 'ideal of service' objectified by the abstraction of the professional standards and guidance and executed in conformity to routines of operational approaches. As a result, the structured methodologies of 'risk-based' auditing mediate independent judgement, in particular in its operational sense.

The study seeks to unveil whether the auditor is capable of transcending the structure of the audit process and client's influence so as to enable independent judgement and fraud recognition. The study consists of questionnaires incorporating a real-life construct case study (i.e. given the characteristics of the client, the subjects were asked to compose audit planning memorandum, assess the risk and estimate the budget of hours for audit testing) and interviews. Qualitative and quantitative methods are employed: narrative analysis and statistical testing.

What emerges is evidence that auditors respond to the (changing) circumstances of the client's environment in two different ways consistent with their attitudes to structure: transcending and non-transcending. The former, being less constrained by the structured audit approach, represents a 'big-picture' perspective. For these auditors the threat of loss of independence may be associated with the judgement restrictions with regard to amount of work assigned for audit testing. In the latter group of more conventional auditors, structure 'bands' the 'big-picture' judgmental orientation; hence, these auditors tend to take to the codification more readily and that results in 'black box' oriented judgements (the 'orthodoxy' of risk/materiality assessments). In other words, structure restrictions affect their operational independence: the ability to determine freely a scope of judgement. These auditors may recognise the problem (of fraud) but not be able to label it. Thus, the evidence reveals that a structured approach is overused in audit and forms an obstacle to the recognition of material fraud. This is an enduring concern since fraud experience is not easily codified to facilitate structured inquiry. Further, the mutual exclusivity of fraud and Non-Audit Services (NAS) recognition was found, i.e. auditors do not consider a fraud flag and a NAS opportunity simultaneously. Whilst one aspect of the study has its origins in concerns that the existence of NAS opportunism diverts attention from fraud recognition, the results reveal only limited evidence to support this.

TABLE OF CONTENTS

Chapter	Subject	Page No
	Declaration.....	i
	Acknowledgements	ii
	Abstract	iii
	List of contents.....	iv
	List of abbreviations.....	x
1	Introductory chapter	
1.1	Introduction.....	1
1.2	Background to the problem and the research question.....	1
1.3	Literature review as a term of reference.....	3
1.4	Research design.....	3
1.5	Scope and methodology of the study.....	5
1.6	Results of the study.....	6
1.7	Limitations of the study.....	7
1.8	Organisation of the study.....	8
1.9	Summary.....	10
2	Audit independence and the client's power	
2.1	Introduction.....	12
2.2	The nature of independence, objectivity and integrity.....	13
2.3	The impact of competition on the audit services market.....	19
2.4	The provision of non-audit services.....	25
2.5	The nature of material fraud and its significance for the auditing profession	33
2.6	The auditor in the context of fraud recognition.....	45
2.7	Summary.....	47
3	Dynamics between professional judgement and structure in the audit process	
3.1	Introduction.....	49
3.2	Underlying philosophies and the operational role of judgement in auditing	50
3.3	Aspects of judgement and decision-making studies in auditing literature....	57

Table of contents – continued

3.4	The system of knowledge in the auditing profession	64
3.5	A framework for professional judgement.....	69
3.6	Summary.....	84
4	Interpretive dimension of auditing: Hermeneutic turn in a methodological framework	
4.1	Introduction.....	87
4.2	Insights from the theory of hermeneutics.....	89
4.3	Social action as text.....	90
4.4	Beyond Ricoeur's hermeneutical point: The medium of institutions.....	95
4.5	Interpretive auditing.....	96
4.6	Standardisation in the auditing milieu and the debasing of practice.....	98
4.7	Summary.....	108
5	Research design and research methods	
5.1	Introduction.....	111
5.2	The qualitative and quantitative methodological mix.....	112
5.3	Research design.....	114
5.3.1	Case study for the first year.....	115
5.3.2	Case study for the second year.....	118
5.4	Collection of data: Questionnaires and interviews.....	120
5.4.1	Mail questionnaires.....	121
5.4.2	Interviews.....	124
5.5	Research population.....	133
5.6	Narrative analysis.....	135
5.7	Statistical analysis.....	136
5.7.1	Chi-test	138
5.7.2	Spearman rank-order correlation coefficient Rs.....	139
5.7.3	Kruskal-Wallis test: Risk assessment across the groups.....	142
5.8	Limitations of the study.....	143
5.9	Summary.....	145

Table of contents – continued

6	Research findings: Experimental results	
6.1	Introduction.....	146
6.2	Profile of respondents.....	146
6.3	Incidence of recognition of a potential fraud flag and/or NAS opportunity within the structured audit approach.....	148
6.4	Incidence of the auditors' anchorage.....	151
6.5	Incidence of auditors' consistency with regard to the structure of the audit determined by the directions of assessed risk and estimated hours for audit testing.....	152
6.6	Auditors' consistency with regard to the structure of the audit determined by the levels of estimated risk and a number of budgeted audit hours for audit procedures.....	156
6.7	Summary.....	160
7	The realm of the real in audit practice	
7.1	Introduction.....	163
7.2	Profile of interviewees.....	164
7.3	The story of the 'realm of the real' in audit practice.....	165
7.3.1	Socialisation processes.....	165
7.3.2	The use of symbolic language.....	168
7.3.3	Hermeneutic context: Dynamics between judgement and structure metaphors.....	171
7.3.4	Predisposition to audit: the role of the firm.....	177
7.3.5	Organisational change: From old to new audit methodologies.....	183
7.4	Learning styles of the auditor and judgement.....	188
7.5	The real story and the dream in audit practice.....	197
7.6	Summary.....	198
8	Conclusions and implications for further research	
8.1	Introduction.....	201

Table of contents – continued

8.2	Insights into operational and apparent independence: Dynamics between judgement and structure categories in the audit process.....	202
8.3	Insights into anchorage in audit judgement.....	205
8.4	Insights into learning styles in judgement processes: Towards the convergence of judgement scope.....	206
8.5	Insights into dynamics between judgement and structure embedded in organisational change: The nature of new audit methodologies	208
8.6	Implications for further research.....	210
8.7	Summary.....	211
	Bibliography.....	212
	Appendix 1.....	233

List of Tables

Table

3.1	Judgement within the audit process.....	52
3.2	Knowledge heterogeneity within the professional firm.....	67
3.3	Kohlberg's stages of moral development.....	77
3.4	The auditor's stages of moral development: A Kohlbergian approach.....	78
3.5	(W)holist and analytical family of cognitive styles.....	81
3.6	Applied strategies for audit judgement and decision making.....	83
4.1	Ricoeurian hermeneutic propositions.....	91
5.1	Case study for year 1.....	117
5.2	Case study for year 2.....	119
5.3	Classification of auditors' discourse in the audit planning memorandum....	123
5.4	Timing of responses.....	134
6.1	Questionnaires' respondents: Demographic characteristics.....	147
6.2	Questionnaires' respondents: Work experience.....	147
6.3	Recognition effect across cases – year 2 of treatment for $\alpha=0.05$	149
6.4	Recognition effect across pairs of cases – year 2 of treatment for $\alpha=0.05$...	149
6.5	The auditors' discourse in the audit planning memorandum: Frequency of comments.....	151
6.6	'Switch effect' – recognition of fraud.....	152
6.7	Structure consistency between the groups of auditors – recognition effect for $\alpha=0.05$	154
6.8	Structure consistency between the groups of auditors – recognition effect for $\alpha=0.05$. Chi-tests.....	154
6.9	Spearman rank-order correlation coefficient R_s – recognition effect.....	157
6.10	Spearman rank-order correlation coefficient R_s – case effect.....	158
6.11	Risk assessments across the recognition effect for $\alpha=0.05$	159
7.1	Interviews' respondents: Across-case distribution.....	164
7.2	Interviews' respondents: Demographic characteristics and work experience	165
7.3	Auditors' perceptions related to actual audit performance: Learning styles in judgement processes.....	195

List of Exhibits

Exhibit

3.1	Assessing the need for judgement.....	54
3.2	The audit judgement milieu: A simple depiction of reciprocally interrelated components of professional judgement.....	70
4.1	Standardisation in the auditing milieu.....	99
7.1	Individual awareness in the audit firm: Personal traits and values versus incentives.....	178

LIST OF ABBREVIATIONS

Official bodies and documents

AICPA	American Institute of Certified Public Accountants
APB	Auditing Practices Board
ASB	Accounting Standards Board
CAJEC	Chartered Accountants Joint Ethics Committee
CICA	Canadian Institute of Chartered Accountants
DTI	Department of Trade and Industry (UK)
ICAEW	Institute of Chartered Accountants of England and Wales
ICAS	Institute of Chartered Accountants of Scotland
SAS	Statement of Auditing Standards
SEC	Security and Exchange Commission (US)
SSAP	Statement of Standard Accounting Practice
NAS	Non-Audit Services

Other abbreviations used in the thesis

C1, C2	Conventional audit ('risk-based' audit) in year 1 and year 2 of treatment
F1, F2	Fraud recognition in year 1 and year 2 of treatment
KW	Kruskal Wallis test
NAS1, NAS2	Non-Audit Services opportunity recognition in year 1 and year 2 of treatment

CHAPTER 1

Introductory chapter

1.1 Introduction

The importance of the audit function rests on the independence of auditors in carrying out their work; that is, the essence of the profession is that a high degree of judgement is required in its practice. In the British tradition a distinguishing feature of the underlying philosophy of auditing is the connection between independent judgement and the concepts of accountability and integrity. These concepts go beyond a 'true and fair view' and the agenda of compliance with auditing standards.

'Audit is about seeking the truth...[Judgement] is, in the final analysis personal and derives from business understanding and experience as well as incisive knowledge of financial reporting and business life...an expert view with personal accountability' (APB, 1994, p. 2 and 5).

Audit judgement is an independent process of deriving understanding and meanings from generic principles by their application in specific contexts of clients' economic reality. Exercising judgement is an integral part of audit, evidenced by the numerous references to professional judgement in auditing standards. In this regard, the auditor relies on standards, but also interprets those standards in conjunction with the client's characteristics and environment. If auditors are to continue to play a vital role in adding credibility to the interpretations of the economic reality of the client hidden in the financial statements, it is essential to address in auditing research the risks and pressures they face in the course of the audit process. The auditor's independent judgement is a focal point for those challenges.

The remainder of this chapter is structured as follows. The following section provides a background to the problem of audit independence, in particular issues addressing the independence of judgement and decision making. The nature of the study, the research question, research design and the methodologies employed to explore this question are then outlined. The subsequent section discusses the findings of the study. Then limitations of the study are briefly discussed. Finally, the organisation of the thesis is presented.

1.2 Background to the problem and the research question

The environment in which audit exists is constantly evolving in relation to the demands placed on it. The credibility of auditors is increasingly being questioned and criticised due to widespread litigation directed towards auditors worldwide (Porter, 1993). In the context of this turbulent

reality, it is worth asking whether the profession is evolving in response to, and keeping pace with, these external changes.

This study addresses the concept of audit independence, in particular behavioural and ethical aspects of independent judgement and decision-making in external auditing. Policy issues in auditing practice, in particular with regard to structural conditions and power relations associated with audit independence are examined. The independence of audit judgement is assumed to consist of two components; that is, independence of thought and independence from the client. Independence of thought is derivative of Power's (1997) definition of operational independence while independence from the client relates to apparent independence (Mautz and Sharaf, 1961). Operational independence refers to the individual capacity of the auditor to freely determine the scope of audit procedures in the process of interpreting the client's operations and financial statements. The standard format of the audit operational approaches (i.e. structure of 'risk-based' auditing), propagated by the audit firms, moderates this individual capacity of the auditor. Apparent independence addresses the nature of the auditor-client relationship. The factors associated with the impairment of apparent independence relate to the forms of the client's power exertion over the audit fees, i.e. in particular the provision of non-audit services to audit clients (hereafter NAS), long audit tenures, and overall high competition on audit services market. The need for audit independence has been recognised by professional bodies, and as a result guidelines restricting specific auditor-client relationships which may impair apparent audit independence have been issued. However, there was no guidance on auditor performance (judgement) associated with impairment of operational independence.

Three highly topical issues are brought together into a single research design. The study explores how the auditor's sensitivity to (1) the client's management (mis)representations, (2) to the possibility of fraud, (3) and to a management (non-audit) services opportunity in the client's environment impacts upon individual audit judgement embedded in a structured audit. This study is the first empirical work which addresses the operational independence of audit judgement in the context of NAS and material fraud. In this study, individual judgement is envisaged as operating within a certain structure of materiality and risk concerns. This structure may provide a threat to the operational independence of judgement. The focus of analysis is applied audit approaches among senior auditors and audit managers. Therefore, the study seeks to unveil whether the auditor's frame of reference goes beyond the structure of the audit process and the client's influence, so as to ensure independent judgement and enhance fraud recognition. The study provides insights into the understanding of the auditor's (lack of) performance in recognising fraud. Because fraud awareness is embedded implicitly in audit judgement processes, the auditor requires a better understanding of the complex range of influencing factors which may result in fraud. Further, a related argument is that the attitudinal stance, personal characteristics and self-

critical awareness of the auditor can be envisaged as significant, predisposing factors in the capacity to achieve penetrative insights into the reality of the client.

The research question is whether or not the auditor is capable of transcending the structure of the audit process and the client's economic power so as to enable a 'big-picture' judgmental orientation; that is, whether he/she is capable of seeing and labelling particular characteristics of the client's environment as determined by the micro-structure of material misstatements and provision of management services. Thus, the issue of fraud is embedded in independence tensions and considered in wider social contexts.

1.3 Literature review as a term of reference

The thesis provides a broad scope review of auditing literature, covering in particular the areas of audit independence, audit judgement and decision making, client's economic power over the auditor, and issues of fraud. This comprehensive overview of literature forms an informative base to the issues of the micro-structure of audit independent judgement under investigation; that is, the case of material misstatements and NAS opportunism embedded in a structured audit environment. On the whole, there are tendencies in the auditing literature to look at audit independence issues separately. In other words, the literature on audit independence consists of compartments where much of the on-going debate is focused on organisational independence, in particular independence in appearance addressing the auditor-client relationship, i.e. tendering issues, competitive pricing and fee-related issues. The genesis of organisational independence research was initiated by Mautz and Sharaf (1961) who for the first time introduced the concept of audit independence as a postulate of auditing. There has been, however, much less research on the operational sense of independence (Power, 1997). Literature addressing forms of client's power exertion over the auditor is very broad and undecided as to whether the provision of management services to audit clients impair audit independence, and whether the auditor trusts (is able to trust) the client's representations in the context of the provision of NAS. Further, auditing literature evokes the need for fraud awareness to be a part of audit judgement process. For this awareness to be present in judgement requires from the auditor a better understanding of the exposures he/she may come across in the decision-making processes and of their implications. By activating independent 'way of seeing' the auditor will be able to transcend the structure of the audit process. The interpretive framework for professional judgement in the auditing milieu emerges as a result of integrating audit independence and audit judgement literature.

1.4 Research design

The empirical work of this thesis is constructed so as to integrate insights from auditing literature with a real-life construct case study. The case study used in the research design is based upon an actual fraud case. The research was designed using abstracted frameworks from an actual case and

with the advice of a technical partner from one of the Big Five auditing firms. Over the course of the consultation, the micro-structure of independent judgement was identified; that is, independence tensions between management consulting service opportunities and fraud possibilities implicit in the overall client's environment and in the client's management representations. Situations were constructed which could be read by the auditor as a potential fraud risk, a non-audit service opportunity, or both. These situations represent the generic independence issue of auditors' 'willingness' to accept client management representations that deflect the auditors' attention from existing fraud problems in cases when NAS opportunities arise. Based on these situations, an experiment was designed so as to examine the auditor's response to the potential duality of interpretations; that is, a deconstruction of how the auditor reads the client's case was undertaken. The phenomenon of management services opportunism is perceived as a form of power exertion by the client over the appointed auditor, in particular over independent audit judgement and the auditor's recognition of material fraud. The auditor may accept given explanations without sufficient facts due to the fear of being replaced, not wanting to challenge and/or to upset the client's management. The study seeks to understand whether the auditor is tenacious in the audit task; not being influenced by economic powers within the structured audit environment. The main purpose of concern with regard to independence of judgement is whether (early) NAS recognition in the client's environment would prejudice (subsequent) fraud risk recognition.

Auditing practice is perceived as hermeneutic practice; that is, the auditor on the job strives to understand and interpret evidence of the client's operations and representations embedded in the context of social institutions and structural conditions, and by doing, so he/she produces assurance in society that these interpretations are trustworthy (Pentland, 1993). This relates to the auditor's operational freedom and capacity to understand and interpret the 'economic text' that is narrated in and behind the client's financial statements (i.e. notion of operational independence). The profession and audit firms, however, propagate a symbol of the 'ideal of audit services' which is objectified by the abstraction of professional standards and guidance and executed in conformity to the routines of operational approaches. Structured methodologies and audit approaches (pre-established structured plans and checklists) are expressions of striving for standardised and legitimate services (Francis, 1994). As a result, structured methodologies for the audit process mediate independence of judgement, in particular in its operational sense.

This research is novel in the sense that there has been no similar judgement study which combined fraud awareness, management services opportunities and management (mis)representations in a single experimental design. Secondly, the experimental studies undertaken to date on audit judgement and decision-making are limited in research design, in that, they have relied entirely on quantitative modelling and data. The methodology used in this study, which is fully discussed in

chapter 5, combines both quantitative and qualitative data. Further, this study provides an explanatory component to judgement performance in audit praxis, acknowledges and explores the embeddedness of professional judgement in wider social and organisational milieu.

This study has both broad and narrow dimensions and is designed between and within subjects. The study is broad in the sense that it embodies a real construct scenario. The experiment is deliberately designed to engage with a number of issues so as to reflect different strengths of fraud flags, different levels of NAS opportunities in the client's environment and of credibility attached to the client's management representations. To provide an authentic setting in the research design, it was necessary to engage with a wide range of literature on audit independence and on audit judgement. A hermeneutic dimension places applied judgement strategies in wider social and organisational contexts. The study has a narrow dimension in the sense that it refers to a single case with a particular construct; the case of the micro-structure of fraud and NAS opportunism. Hence, the research design enables both narrative and statistical analyses of the auditors' responses to changing circumstances of possibility of fraud and NAS opportunities in the client's environment. A two year time span is introduced within the case study to examine how the auditor's cumulative knowledge and experience of the client impacts upon his/her judgements in the audit process. The research was conducted among audit seniors and audit managers from Big Five auditing firms across the UK. The structure of 'risk-based' auditing was deliberately implemented in the construct since that structure was operationalised at the time research was being conducted (Bowrin, 1998). Strategic audit methodologies were in the processes of implementation within the Big Five audit firms. The experiment was piloted and tested in association with the Institute of Chartered Accountants of Scotland.

1.5 Scope and methodology of the study

The review of previous studies suggested a number of methods that might be applied to investigate the effects of the client's economic power and the standardisation of audit process on the independence of audit judgement and fraud recognition. The methods are quantitative and qualitative, with quantitative methods being predominant. The different methodologies used in these previous studies indicate that both qualitative and quantitative methods have their own strengths and weaknesses, and no single method used in isolation is likely to be completely successful. Studies that use only one method are on the whole more vulnerable to errors in comparison with the use of dual or multiple method design in which different types of data provide cross-data validity checks. Thus, in this study qualitative and quantitative methods are employed; that is, narrative analysis and statistical testing. The methodological mix allows the capturing of aspects of the phenomenon under investigation in a more complete and holistic manner.

The study consists of questionnaires incorporating a real-life scenario and interviews incorporating a process tracing exercise. In the case scenario (given the characteristics of the client) the subjects were asked to compose an audit-planning memorandum, and subsequently to assess the audit risk and to estimate the budget of audit hours for audit testing. The process tracing exercise allowed the examination of the judgement formulations over the client's case and validated the categorisation of the questionnaire respondents. Interviews enabled the location of the study in wider socio-organisational contexts and provided some insights into the affective and cognitive aspects of operationalised judgement strategies, in particular relating to auditors' background and experience.

1.6 Results of the study

The results offer indicative evidence of the relevance of different learning styles in the recognition of fraud in a structured audit environment. What emerges is evidence that auditors respond to the changing circumstances of the client's environment in different ways consistent with their attitudes to structure; that is, transcending and non-transcending practitioners. The former being less constrained by the structured audit approach, represent a 'big-picture' perspective (into this category fall those auditors who recognise either fraud or NAS opportunity). These auditors are able to go beyond the structure of operational approaches and 'see' the particular micro-context of the client's environment. For these auditors the threat of loss of independence may be associated with judgement restrictions with regard to the amount of work assigned for audit testing. In the latter group of more conventional auditors, structure 'bands' the 'big-picture' judgmental orientation; hence, these auditors tend to take to the codification more readily and that results in 'black box' oriented judgements (the 'orthodoxy' of risk and materiality assessments). That is, these auditors tend to read the case in terms of audit (non fraud) risk and materiality, without addressing either fraud or non audit services. These auditors may recognise the problem of fraud whilst not being able to label it. This group emerges as highly structured thinkers treating the audit more as a technical activity. In other words, in this group, structure restrictions affect operational independence; that is, the ability to freely determine the scope of judgement.

Whilst one aspect of the study had its origins in concerns that the existence of NAS opportunism diverts attention from fraud recognition, the results reveal only limited evidence to support this. The mutual exclusivity of fraud and NAS recognition was found since auditors did not consider a fraud flag and an NAS opportunity simultaneously. However, the findings suggest that early NAS recognisers are also fraud recognisers (in second year of treatment). There are a significant number of auditors able to switch their judgement focus from NAS recognition in year one of treatment to fraud recognition in the second year. Those versatile auditors (within 'big-pictured' category) by thinking more broadly are capable of responding to both the NAS and fraud dimensions, depending on the circumstances. Further, some conventional auditors in the first year (i.e. who did not recognise fraud or NAS) become 'big-pictured' in the second year of treatment, recognising

fraud or NAS in that year. In short, different patterns of judgement performance emerged; that is, conventional (non-transcending of structure) and 'big-picture' orientations (with versatile sub-category). The latter represents auditors capable of transcending the structured audit approach. The statistical testing explored whether and to what extent these different groups of auditors perform differently under the format of 'risk based' auditing.

Overall, the 'non-recognisers' group remains significant. These did not recognise fraud or NAS in either year. Thus, the tentative conclusion is that a formal structured approach to auditing is a possible threat to fraud discovery (i.e. operational independence threat) whilst a pressure on audit staff to recognise and to pursue NAS opportunities for the firm is not. However, the latter statement has to be moderated in the sense that the experiment provides some evidence that NAS recognisers did not increase audit work in response to fraud recognition; that is, despite awareness of higher risk, they tended not to increase the budget of hours for audit testing or some even lowered the budget (i.e. an apparent independence threat). Thus, the evidence reveals that a structured approach is overused in audit and forms an obstacle to performance in fraud recognition. This is an enduring concern since fraud experience is not easily codified to facilitate structured inquiry. In other words, the concept of fraud is not easily codified as audit knowledge within a structured audit framework. It requires auditors' creative and critical thinking within a highly diffused and flexible environment. The results of statistical analysis are indicative and auditors' performance was further explored through narrative analysis.

Since auditors responded differently to the changing circumstances of the client environment consistent with their different attitudes to structure, which affected their judgement performance, mixed teams could be built in audit in order to increase fraud recognition. That is, the audit teams should consist of those auditors who see 'big-picture' and those who are able to translate such a picture into a structured inquiry. Further, to activate critical, independent reasoning in the audit judgement process and to broaden individual thinking capacities within underlying frameworks, holistic approaches to auditors' education might be promoted.

1.7 Limitations of the study

The limitations of the study, which are discussed in chapter 5, are related in particular to subject variation and the partiality of interpretations. A related limitation common to all experimental research is the question of external validity. Can the results of the study be generalised to a whole population of senior auditors and audit managers or has the firm a particular culture which has influenced subject responses (Trotman, 1997)? Is there a common culture throughout the auditing profession or do respondents adapt to the culture of the particular audit firm? The demographic component of the questionnaire ascertained subjects' experience profiles. Interviews allowed the researcher to gain insights into auditors' personal traits in relation to their responses in the case

study. Interviews also helped to situate the research results in the contextual setting. Although the partiality of representations related to subject selection and to incompleteness of interpretations needs to be addressed as a limitation of the study affecting its external validity, on the other hand, the in-depth analysis stemming from interviewees' narratives simultaneously strengthens the study, and allows the possibility of assessing inter-linkages between the socio-organisational context and the dynamics between judgement and structure categories in the audit processes.

1.8 Organisation of the study

The thesis is organised so as to provide a comprehensive discussion on issues of independent audit judgement. Further, the study explores the auditor-client relationship in the context of the provision of NAS and fraud recognition. This is further illustrated by citing empirical instances of how the structure of 'risk-based' auditing mediates individual audit judgement. The thesis consists of eight chapters.

This (first) chapter presents a broad overview of the research, its objectives and background to the problem of audit independence. Research methods and findings of the study are also discussed.

The second chapter on audit independence and the client's power discusses issues of audit independence in the context of the client's economic influence over the appointed auditor, in particular associated with the individual auditor's ability to withstand the client's pressure. The nature of audit independence is first discussed. Then, the chapter presents dimensions of the client's power affecting audit performance, including the client's financial condition and related issues of the joint provisions of NAS and audit, the practise of low-balling, tendering issues, auditor switching and opinion shopping. The literature on management representations is implicit and therefore translated into the dynamics of the client's economic influence. A consensus has not been reached as to whether or not severe competition on audit market services and thus, the client's bargaining power, and related issues of joint provision of NAS and audit, lead to an impairment of audit independence and/or have a deleterious effect on the quality of the audit performed. Issues of management fraud and audit judgement in that context are also discussed in this chapter.

The third chapter presents an overview of the professional judgement and decision-making literature and places individual judgement in the structured audit environment. The systematisation of knowledge in auditing is also presented. Most studies on judgement and decision-making have focused heavily on quantitative assessments of the auditor's performance, lacking a conceptual framework of the auditing milieu in which judgement performance is formed and transmuted. Drawing upon the concept of auditing practice as a social construct and locating the audit judgement milieu as being embedded in the wider structural and organisational contexts, a

theoretical framework for the study was developed. This conceptual framework encompasses a widely defined environment comprising of: (1) the auditing profession with its body of knowledge, legitimacy claims and standardisation processes, (2) government and its laws, (3) audit firms with their cultures and politics, (4) competitors and pressures to retain clients and pressures for NAS provisions, (5) clients with their economic powers, (6) financial statements' users evoking their reporting needs and quality requirements, and (7) a widely defined society with its values and opinions. In the context of this milieu, the aspects of standardisation towards more efficient and controllable audits and legitimacy processes over auditors' liability are discussed. Thus, this chapter unveils background to tensions between structure and judgement metaphors in audit process.

The fourth chapter presents the insights into interpretive dimensions of auditing practice. Drawing upon phenomenological hermeneutics, the study explains that the auditor on the job creates judgements and simultaneously shares, replicates and mediates structures. That is, the objective conditions of the audit firms are integrated with subjective understandings that simultaneously enable and constrain individual audit endeavour. Dynamics between the auditor and 'reading' of evidence as economic text are embedded in the context of the interrelation between anticipated components of the audit judgement milieu and research findings. The debasement of critical reasoning in auditing practice through tensions between structure and judgement metaphors is here discussed.

The fifth chapter is devoted to the presentation of research design and discusses the research methodological mix; that is, qualitative and quantitative approaches. A combination of methods was used in the study since both qualitative and quantitative approaches have their strengths and weaknesses. This chapter discusses the two-stage process of data collection, being a case study survey based on questionnaires and semi-structured interviews with a process tracing exercise. This twofold strategy increased the likelihood that the picture emerging from the research represents a reasonable cross-section of insights into judgement strategies in relation to the structure of the audit process in the context of fraud and NAS opportunity. The limitations of the study are also discussed.

The sixth chapter presents the results of the statistical analysis of questionnaire data. This chapter presents evidence relating to auditors' different performance in judgement strategies within the structure of 'risk-based' auditing. The main part of this chapter reports on the effects of client's management representations, NAS opportunism and the structured audit process on the independence of audit judgement and decision making at the planning stage of the audit process. Firstly, the incidence of the auditor's scope in judgement performance is discussed. Secondly, the incidence of anchorage of the auditors' responses (concerns) is presented and explored. Finally,

the incidence of auditors' consistencies with regard to the structure of 'risk-based' auditing are discussed; that is (1) consistency with regard to the direction of risk and the hours for audit testing applied in year 1 and year 2 of treatment, and (2) consistency with regard to the value of the assessed risk. What emerged from the study is evidence that auditors respond differently to the changing circumstances of the client's environment consistent with their different attitudes to the structure of the audit process; that is, transcending ('big-pictured') and non-transcending (conventional) individuals.

The seventh chapter is devoted to the presentation of the auditor's story of the 'realm of the real' of audit operational practice. This chapter discusses the ways in which professionals perceive themselves as the members of a distinct profession, and as the members of the audit firms they work for, and seeks to unveil whether they value the independence of their individual judgements. To find out whether audit independence is threatened in the organisational context, in particular in its operational sense, there is a need to investigate individual perceptions and awareness of the capacity for provision of the audit services, and how this awareness manifests itself in patterns of judgement and decision-making. Further, as audit firms promote certain ways of being; that is, certain behaviours, the question of whether the firm promotes awareness for additional services (NAS opportunism) was raised. Hence, this chapter provides insights based on the interview data into individual experiences of the dynamics between audit judgement and the structure of the audit process within the audit firm in form of the auditors' stories. Within the story of the 'realm of the real' auditors themselves present their experiences of socialisation processes within the firm and the role of the audit firms in the formation of awareness of how to deal with judgement-structure tensions, i.e. predisposition to audit. The story is told with the application of symbolic language where dynamics between judgement and structure metaphors are revealed in the hermeneutic context of practice. The auditors' strategies for judgement and decision making seemed to be influenced by their family background and education and then reformed and deformed by the socialisation processes within the audit firm and professional training. What emerges from the story is the unfolding of organisational change and associated concerns related to the introduction of new audit methodologies. This chapter confirms the existence of two different attitudes to structure of the audit process; that is, existence of transcending and non-transcending practitioners.

The eighth chapter presents a summary of the findings and draws conclusions based on the research data presented in the study. Implications for future research are also discussed.

1.9 Summary

In this chapter, it was emphasised that although the auditing profession recognises the problem of audit independence by issuing guidelines which restrict specific client-auditor relationships, threats associated with independence of audit judgement, i.e. operational independence, have not been

extensively addressed. This study, which is both descriptive and experimental in nature, seeks to address this issue by examination of audit operational approaches in judgement strategies within a structured audit environment in the context of the client-auditor relationship. In addition, it attempts to explore further how judgements are formulated in the wider contexts of structural conditions and organisational relations and looks at the auditor's background and experiential factors. The research methodology employed to meet these objectives was outlined and its relevance and limitations discussed. The chapter concludes with an overview of the thesis.

CHAPTER 2

Audit independence and the client's power

2.1 Introduction

Auditor independence has always been a fundamental concept to the auditing profession and the essence of its philosophical structure (APB, 1994). The dilemma the profession currently faces is one of maintaining auditor independence from the management of the audit clients. Immense competition on audit market services creates a particular type of pressure, related to the acquisition and maintenance of audit clients. This pressure is very likely to have an adverse impact on the quality of the audit performed. Since the client's management is frequently able to exert pressure on the appointment, the remuneration and the removal of the auditor to an extent which causes tensions and incentives for collusive and non-independent activity, it is important for the profession to identify the causes of these pressures and to assess the extent to which the auditor is able to resist these pressures.

This study intends to contribute to a better comprehension of auditor independence by the examination of the interactive influences between the level of the auditor's scepticism applied in the audit judgement and of the client management's economic power over these judgement processes (especially in the context of provision of NAS). An objective of this chapter is to discuss the means by which an audit client exerts a coercive power over the independent judgement processes of the auditor. Firstly, the nature and concepts of independence in the auditing profession are discussed with reference to relevant literature on audit independence. Much of prior auditing research has focused on the profession's assertion of independence, i.e. apparent independence. Secondly, dimensions of the client's economic power affecting audit behaviour are presented. These dimensions include: client's financial condition, audit fee tendering, the practice of low-balling, auditor switching and client's opinion shopping. A consensus has not been reached in prior research as to whether or not such severe competition leads to impairment of audit independence and has a deteriorating effect on the quality of audit performed. Thirdly, a literature review on the provision of NAS is presented, in particular regarding the joint provision of audit and NAS. Some studies suggest the impairment of audit independence occurs in cases of the joint provision of audit and NAS, while other studies indicate the positive effect of such provision due to the existence of knowledge spillovers from the joint provision, i.e. an enhancement of the audit firm's knowledge concerning the client and its business. The following section discusses the nature of fraud, its meaning for the auditing profession and the main research

on fraud. Finally, a discussion of the organisational reality of the individual auditor in the context of fraud is presented. This section discusses the importance of the auditor's scepticism in independent judgement processes and in the recognition of material fraud.

2.2 The nature of independence, objectivity and integrity

Since the Companies Act 1900 the auditor in the UK has been required by law to be independent of his/her clients. The legal requirement for independence came almost half a century before any requirement for the professional qualifications. The importance of independence lies in the role society expects of the auditor. Since ownership and control of the companies are vested in the shareholders and management, and there has been over time increasing separation of the two, the auditor acts so as to give assurance to the shareholders on information provided by management in their stewardship role. To fulfil this role the auditor has a fundamental responsibility to exercise the highest standard of professional judgement, which is based on three interrelated concepts of independence, objectivity and integrity. The concept of auditor independence is integral to the professional code of ethics and the auditing standards. In the UK the Auditor's Code to Professional Ethics (ICAS, 1996) provides a definition of independence incorporating the concepts of objectivity and integrity:

'Professional independence is a concept fundamental to the profession. It is essentially an attitude of mind characterised by an objective approach to professional work and integrity which implies not merely honesty, but fair dealing and truthfulness' (Statement 1, ICAS, 1996).

The notion that independence is an attitude of mind is only tangible for individuals who hold a deontological view of life, perceiving certain actions as morally obligatory, regardless of the consequences that may result from these actions (Moizer, 1991). As the auditor is assumed to have no incentive associated with financial statements to be dishonest, he/she is presumed to be independent of both the company being audited and of its managers. Philosophically, auditors are supposed to serve society. Mautz and Sharaf (1961) define auditor independence as a lack of bias in forming judgements, and so the auditor can be employed to report on the truthfulness of the managers' financial statements. They further state that there is a 'social contract' between the auditing profession and the rest of the society, which establishes the reasons for the auditor to remain independent. The auditing profession recognises a dual connotation in the concept of audit independence; independence in fact and independence in appearance (Mautz and Sharaf, 1961). For the auditor to be independent implies a capability to think and to act independently, whilst simultaneously being seen by third parties as independent (Flint, 1988). Independence in fact has been

defined in terms of honesty, objectivity and a mental attitude. Shuetze (1994) argued that independence is an abstract concept, being defined by a state of mind partly synonymous with honesty, integrity, courage and character. He further stated that the cynical world requires more from the auditor than mere declarations of independence. Accordingly, the auditor is expected to tell the truth as he/she sees it being capable to resist any influence either financial or sentimental, which could potentially turn him/her from that course. In other words, the auditor has to have 'inner strength' to report difficult issues¹.

'It is the inner strength that when you enter a room and smell damp, you look under the floorboards, rather than close the door and go to the management and ask somebody else to do the job for you' (Percy, 1999, p. 4).

The American Institute of Certified Public Accountants, hereafter AICPA, stated that to be independent, the auditor must be intellectually honest (AICPA, 1991). The European Commission in its Green Paper defined independence as the state of mind which has regard for all considerations relevant to the task in hand (European Commission, 1996). Independence in appearance has been defined by professional bodies as a state of being free of interest in and/or relationship with clients. The Chartered Accountants Joint Ethics Committee stressed the importance of being free of any obligation with the client, in order that the auditor may appear to be independent (CAJEC, 1995). The auditing profession is organised around a central ethical conflict. The client 'hires' the auditor and pays the fees but the auditor is supposed to conduct the audit in an independent fashion adhering to the profession's 'covenant with society' (Briloff, 1966) to audit in the interest of society. The appearance of independence is maintained by a number of detailed rules about forbidden commercial and familiar relationships between the auditor and the client (Reiter, 1997).

Some researchers, who were concentrating on independence in fact, defined independence in terms similar to those used by the professional bodies. For instance Bartlett (1993) defined independence as an unbiased mental attitude in making decisions about audit work and financial reporting. Other researchers have operationalised the definition of independence. DeAngelo (1981) defined independence as a conditional probability that, given a breach is discovered, the auditor will report that breach. Simunic (1984) argued that any situation which increases the probability that the auditor will not truthfully report the results of his/her investigations can be viewed as a threat to independence.

¹ A concept of 'inner strength' derives from Hatherly (1996).

Independence can be envisaged in terms of duality of organisational and operational concepts (Power, 1997). Organisational independence relates to the individual auditor and the profession, whereas operational independence is linked to the audit process itself.

‘There are two senses of independence: organisational and operational... Arrangements for the organisational independence concern the manner in which the auditor is appointed, the development of ethical rules to ensure impartiality and the questions over the compromise of the auditor’s role by the provision of NAS... Compared to organisational independence, operational independence has more to do with the audit process itself. Here the concern is more with [auditors’] *capability*’ (Power, 1997, p. 132, emphasised in the original).

In operational independence the concern is less to do with the auditor’s willingness to be independent as with the question of his/her capacity to do so. Power’s (1997) discussion of the operational independence is set out in terms of the interrelationship with the information subject to audit and the existence of a separate body of knowledge available to the auditor. Operational independence is segregated in informational independence and epistemic independence. Informational independence concerns the problem with auditing fundamental dependence on information supplied by the client.

‘The informational independence refers to the problems of information asymmetry between regulator and regulated. The auditor is always informationally dependent, trusting at least some of the representations of senior management’ (Power, 1997, p. 133)

In epistemic independence, knowledge upon which the conclusions of the audit is built must be independent. No matter how independent the auditor is in fact or in appearance, a knowledge base that is biased towards serving the interests of the client may jeopardise this. Knapp (1985) observed that independence of audit task is associated with an act of persuading the client’s management to do what they sometimes do not want to do. Epistemic independence is consequently about having a knowledge base that is independent of interests in the client. The knowledge base in auditing is biased towards the client by the focus on adding value to the audit, being aggravated by the direct involvement of the client and in choosing the areas to be audited. Where clear rules of the client’s conduct and techniques for determining compliance with these rules exist, the audit process is epistemically independent of the client. Epistemic independence is linked to the possession of a knowledge base, which is independent from the client. With epistemic independence being compromised, the independence of the individual auditor, as well as the profession, are compromised in turn. The social and political requirements for accountability and control demand that auditing firms redefine the nature of audit and have a fresh look at concepts of independence, in

particular the notion of operational independence, in a way that legitimises this change towards the public trust in audit independent judgement.

In this study, operational independence, derivative of Power's (1997) concept, relates to the auditor's capacity to determine the scope of the audit process, and the freedom to understand and interpret the 'economic text' of the client's financial statements. Hence, the operational sense of independence relates to the interrelation between the nature of the audit process itself and the auditor's personal traits. First, the auditor must have programming independence, i.e. the freedom to decide the character and the scope of the audit procedures and techniques. Secondly, the auditor must have investigative independence, i.e. access to legitimate sources of information regarding the organisational areas and managerial policies to be examined on the audit engagement. Finally, the auditor must have reporting independence, being the freedom from outside control or influence in the expression and recommendations with regard to the audit opinion (Power, 1997, p. 133). Hence, the means of producing the audit and the end-product of the audit process (an audit opinion) depend on the auditor's judgmental and mediating capacities.

In the early stages of audit independence research, Mautz and Sharaf (1961) discussed two aspects of organisational independence, namely the individual auditor independence – in fact, and the apparent independence of the auditors as a professional group. However, they did not discuss independence of the audit process. Further, legitimacy of the profession depends upon its perceived independence. Professional standards appear to be bound up in the profession's private interest whilst being couched in terms of societal interests (Willmott, 1993).

In other words, the profession creates narratives of legitimacy from the values of the surrounding society². Mautz and Sharaf (1961) referred to independence of the profession; the necessity to create and maintain the general public's trust in the independence and integrity of the auditing profession (Parker et al., 1989). Hence, the research tradition emphasises the necessity to create and maintain the trust of the general public in the independence and integrity of the profession.

² For example, in the US, the 1917 code of ethics of the auditing profession embedded themes from Protestantism, Victorian idealism, and pragmatism. The 1988 code reflected the values of contemporary culture, such as the primacy of the individual, and the reliance on calculative rationality (Preston et al., 1995).

In practice, audit firms directly influence programming, investigative and reporting judgements in structuring the audit processes; that is, propagate a standard format in the audit. Structure in the form of procedures and methodologies restricts the options of the auditor concerning the conduct and reporting of the audit, thereby reducing his/her independence (Cushing and Loebbecke, 1986). In other words, a lack of operational independence implies in practice that structured audits are conducted, regardless of whether or not it is appropriate.

Much on-going debate relates to the concepts of apparent independence and addresses the nature of the auditor-client relationship. The professional standards require the auditor to have reasonable knowledge of the client's business; hence these auditor-client relationships seem to be implicitly fostered by practice. Setting a close professional relationship may facilitate impairment of independence. Hence, audit independence can be threatened by the nature of this relationship when the knowledge base is biased towards the client (Lee, 1988). The client exerts certain power over the auditor and this can be reflected in the budget pressures faced by auditors (Windsor and Ashkanasy, 1995; Bartlett, 1993; Lee, 1988), tender threats (Moizer, 1995), and competitive pricing of audit services (Kilcommins, 1997; ICAEW, 1995). Knapp (1985) argued that the ways in which the ability of the auditor to resist management pressure is perceived relates to the perceived independence of the auditor. The factors associated with the impairment of audit independence with its detrimental effects on audit quality include: the highly competitive audit market, the provision of NAS to the audit clients³, long audit tenures, and a lack of an audit committee (Beattie et al., 1997).

Company legislation too recognised the difficulty of maintaining the appearance of independence in situations in which the auditor is verifying the representations of a management who have the power to appoint the auditor. Such legislation requires that the auditor is appointed by the shareholders. Although, it is the shareholders' responsibility to appoint and remunerate the company's auditor, in practice it is unlikely that they will disapprove of the recommendations of the directors (Gwilliam, 1987).

Regarding auditor appointments in the UK, the majority of shareholders are institutional ones who are principally interested in achieving portfolio returns. The auditor, therefore, is effectively paid by the directors of the company and, hence, this fosters an economic

³ Clearly, the provision of NAS increases the economic bond between the auditor and the client, however joint provision may be beneficial due to knowledge spillovers. There is no direct evidence that NAS provision by the auditor impairs audit independence, this does not however preclude an impact upon perceived independence due to decline in the monitoring value of the audit.

incentive for the auditor not to offend the client while verifying management representations. Furthermore, the auditor may have some incentives not to report truthfully.

The majority of the previous studies on auditor independence examined perceived audit independence and these were mostly US based. The development of auditor independence in the US in comparison with the UK has differed. In the US the professional bodies were slower than regulatory agencies to adopt the more stringent independence rules in a comparison with the UK (Kilcommins, 1997). Hence, it is not certain whether the results from the non-UK studies can be directly applied to the British context. Further, the effects of audit market competition and especially the provision of NAS on auditor independence have not been investigated extensively in the UK (Mitchell et al., 1993; Sikka and Willmott, 1993; Gwilliam, 1988; Boys, 1986). Based upon British law cases, Gwilliam (1988) identified the instances when auditor independence was impaired having adverse effects on quality of audit. Factors which contributed to these compromises included: the auditor having financial interest in, or personal links with the clients, and the over-reliance on dominant directors for audit evidence. The instances when the auditor was insufficiently critical in their acceptance of representations from dominant client's management were analysed in past Department of Trade and Industry Inspectors' reports (Boys, 1986). Sikka and Willmott (1993) and Mitchell et al. (1993), based on the reviews of these DTI Inspectors' reports, identified instances where auditor independence has been compromised by the provision of NAS to the audit clients⁴.

Much prior research on auditor independence was focused on the profession's assertion of independence. Shaub et. al. (1993) argued this is because the auditing profession tends to rely on the structure of authoritative codes of ethical conduct and professional standards as constituting the professional knowledge base. Further, the codification of professional ethics and bureaucratisation of professional knowledge facilitate the processes of professional self-control (Parker, 1994) and self-regulation (Willmott, 1993).

⁴ Davidson and Emby (1996), and Kilcommins (1997) summarised studies which looked at the perceptions of both financial statements users and auditors themselves with regard to issue of the audit firm offering NAS services to their clients. These studies provide contradictory results as to the impairment of independence by the joint provisions of audit and NAS.

'We live in the world where whenever something goes wrong, politicians believe it can be sorted by another dose of legislation and regulation. Lengths of the rulebooks and the length of the acts of Parliament suggest that nobody can follow all laid down rules; it would be impossible to keep them in the head. Nowadays there are many rulebooks and checklists and the auditor looks to the completion of that checklist as the completion of the audit' (Percy, 1999, p. 7).

Jeppesen (1998) examined the ways in which the Big Five audit firms have in the recent years redesigned their audit product as a result of the competition. The audit has become a client-driven; 'adding value' commodity, where the apparent independence premise that the auditor should not make managerial decisions is threatened. However, it could be argued that there is a threat that the auditor may become predominantly commercially-oriented, concerned with selling NAS to clients.

In this study, the emphasis is put on the nature of the audit process as a factor which influences the auditor's operational independence. The argument is that standardisation of operational audit approaches may inhibit the ability of the auditor to make appropriate judgements. Essentially, if the auditor becomes process driven, the quality of audit, in respect of fraud recognition may fall. That is, the capacity of the auditor to be vigilant to potential fraud may be undermined by process-orientation.

The preoccupation with apparent independence precludes academic debate related to operational independence and runs the risk of prejudicing the ability of the profession to discover fraud. Until recently, little research has focused specifically on operational independence as related to affective aspects of independent judgement and the audit process itself.

2.3 The impact of competition on the audit services market

The relaxation of ethical guidelines concerning advertising and solicitation has led to additional competitive pressures on the British audit market, that is indicated by an increased instability of the auditor-client relationship. There is a constant pressure applied upon the audit firms to acquire new, and maintain existing clients (Beattie et al., 1997). As the traditional audit service is not a growth industry, its low profitability produces concomitant pressure on the audit firms to provide value to their clients in other ways which include consulting, management advisory services and contracting to perform corporate functions (e.g. internal audit) (Reiter, 1997). Subject to the competition in the British audit market,

economic pressures are attributed to the tendering bids, the aggressive fee negotiations, the practices of opinion shopping and of low-balling. Similarly, in North America the profession attributed audit market competition to intensive pricing practices, and time and budget pressures (Cohen Commission in US, 1978; Adams Committee in Canada, 1978). Windsor and Ashkanasy (1995) claimed that the situational factors which exert pressure on the auditor, and accordingly influence his/her behaviour being reflected in the quality of audit performed, include the following dimensions of client's management powers: the client's financial condition, the level of the audit fees and the tendering processes. Among the factors identified in the literature which might threaten auditor independence and have a deleterious effect upon the quality of audit performed, the provision of NAS to the audit clients has been the subject of the most extensive debate (Beattie et al., 1997). In some circumstances management may use the NAS income as a lever to obtain a more compliant auditor particularly in instances when NAS are perceived as profitable contracts for the audit firm (Kilocommins, 1997). The impact of the provision for NAS on auditor independence and his/her individual judgement is discussed further in a following section of this chapter.

The following dimensions of client's management power having an impact on auditor behaviour have been identified in the literature: (1) the client's financial condition, (2) size of the audit fees, (3) the practices of low-balling and whether or not the client calls for tenders for the audit work, (4) auditor's switching, and (5) the client's opinion shopping.

(1) Client financial condition

The auditor dealing with the client in a poor financial position is likely to face a higher level of legal liability than when the client is in a good financial condition (Palmrose, 1987). It follows that the auditor would be more likely to exercise a greater amount of caution in instances when he/she deals with the client in a poorer financial state. Anderson and Zeghal (1994) stated that the financial condition of the client is reflected in the charges of the audit fees since it is the auditor who bears the risk of legal liability to third parties for any losses attributable to misrepresentations in the audited financial statements. The auditor deals with the risk of litigation either through an increase of time spent on the audit to ensure that no material misstatements exist or through the charges of a premium to compensate the risk associated with the audit. In either instance higher audit fees would be charged. Further, a poorly performing client might be in a need of management consulting service. In that sense, the auditor may deal with pressures associated with the provision of NAS, i.e. pressures to recover audit losses through NAS.

(2) Size of the audit fees

Mautz and Sharaf (1961) perceived the problem of the auditor's dependence on the client's fees as an economic factor that could affect auditor independence. They argued that the client's management has an inherent bargaining advantage over the auditor because the auditor depends upon these fees for their livelihood. Beattie and Fearnley (1995) explored factors which motivate the management of the UK listed companies to change the auditor. They found that the level of audit fees were the main reasons cited by the client's management for auditor change. They further found that of those companies that considered a change in the auditor, 73% did not actually do so due to audit fee reduction. Thus, the level of the audit fees is likely to be perceived as both a key precipitation of the auditor change and a key factor in retaining the auditor. Knapp (1985) and Gul (1991) argued that the auditor is more responsive to client's management power in instances when the client provides a significant portion of the audit firm's income.

The size of audit fees is closely related to time budget pressure, since audits are controlled by means of time budgets for different phases of the work. The audit fees are a function of time spent on the audit where time budgets are set as targets for the auditor. Close to reporting deadlines the auditor may reduce time assigned for tasks by taking unapproved short cuts, for example by rejecting the problematic items from the samples, by testing fewer items than reported or simply by ignoring errors. Otley (1996) argued that the auditor's reaction to a shortfall in the time budget has an important implication on the quality of audit being performed through the cost-quality dilemma. While the level of cost is related to the number of hours being assigned for audit, the client's management, being concerned with short term profitability, is likely to insist on a decrease of costs. The quality of audit, however, is a long-term issue.

(3) Low-balling and tendering

Since excessive competition in the audit market affects the pricing of audit services, it has been argued that it may encourage practices of low-balling and tendering. The practice of setting the audit fees below the costs on the initial audit engagement, known in the literature as low-balling, is cited as a factor being likely to impair audit independence. DeAngelo (1981) argued that low-balling itself does not constitute a threat to auditor independence, since the initial fee reductions are sunk costs and they have no effect on either the magnitude of future rents or on audit independence. Thus, they seem to be irrelevant for future decision making. She further argued that the practice of low-balling lessens the competition in the audit market for expected future rents. Simon and Francis (1988) suggested that contrary to the prediction from economic theory, the sunk costs do significantly affect subsequent

decision making. They argued that since a considerable investment is made to obtain the new client, this could motivate the audit firm not to lose the client, even in the presence of serious disagreement between the client's management and the auditor. Consistent with Kunitake and White (1986) who argued that over a period of investment recovery, i.e. the recoupment of the audit fees, an initiative to please the client may motivate the auditor to go beyond ethical boundaries of practice. Simon and Francis (1988) and Trupen (1990) found evidence of price cutting on initial audit engagements that persists through the first three years of the audit engagement. Simon and Francis estimated that the discount to be 24% in the initial year and 15% in the next two years. Yardley et al. (1992) argued that empirical evidence of persisting low-balling indicates that price competition may be the dominant feature of audit market behaviour.

The problem of the low-balling practice has recently increased in importance in the UK since a great number of companies seek to contain audit costs by putting the provision of audit services out to tender. An ostensible aim of the tendering process is a reduction of the audit fees. Such reasoning may be as well a way of making the removal of the auditor more acceptable to the public. Windsor and Ashkanasy (1995) argued that, in instances where the client firm invites the prospective auditors to tender for audit at the competitive costs, there is a risk that the auditor may experience a difficulty in remaining independent. This is because the client's management can threaten to replace the auditor. In other words, client management can use the tendering process to place more of an economic pressure on the auditor's behaviour, and accordingly to impair auditor independence.

(4) Auditor switching

The ability of the auditor to resist management pressure has also been associated with severe competition of audit services. Sterling (1973) noted that in conflict situations the audit firm lacks the power to convince the client to accept the auditor's viewpoints. According to Sterling (1973), both a resistance from the client and the auditor's lack of power threaten the independence of the auditor. Shockley (1982) and Mitchell et al. (1993) argued that high competition leads to auditor's switching (the existing audit firm is replaced by a new firm, more compliant with the client's wishes). The effects of audit market competition on perceptions concerning the auditor's ability to resist client's management pressure was undertaken by Gul (1991). In his experiment where the level of the market competition was manipulated, he found that, in instances when the competition has been set as high the auditor was perceived as being more likely to resolve the conflict in favour of the client, compared with the instances with low levels of competition. Gul (1991) concluded that this result may have been caused by beliefs that the client may be tempted to replace the existing

auditor with a more complaint auditor. In the context of the audit firm being concerned with the threat of a replacement, the auditor seems to be less willing to resist management pressure and more likely to compromise his/her behaviour. Contrasting results were provided by Kirshnan (1994) who found that the auditor, realising a possibility of being replaced, is likely to treat the client-switchers more conservatively in issuing the audit opinion. Chow and Rice (1982), Mangold (1988), Kirshnan and Stephens (1996) found a positive association between the issuing of a qualified opinion and a tendency to 'switching' practices. The client receiving a qualified opinion was more likely to switch to another audit firm. Kirshan and Stephens (1996) further claimed that the auditor, having realised the threat of being replaced, was more likely to issue a qualified opinion to client-switchers. Chow and Rice (1982) found a significant association between a receipt of a qualified opinion and a tendency to switch to another audit firm within a year. Mangold (1988) found that companies switching auditors had received significantly more qualified opinions in the two years prior to and in the second year following a switch than companies that did not switch. Having established an association between switching practices and a receipt of a qualified opinion, Chow and Rice (1982) investigated whether client-switchers seemed to choose the audit firm which gives fewer qualified opinions and whether clients who switch after receiving a qualified opinion tend not to receive a qualified opinion from the subsequent firm. They however found little evidence in support of either proposition.

Levinthal and Fichman (1988) examined the effect of the duration of an auditor-client relationship on the client's propensity to switch the firm. They found that the rate of switching was relatively low, but increasing, during the first three years of the auditor-client relationship and highest during the fourth year, and declined thereafter. Similarly to findings by Chow and Rice (1982), Mangold (1988) and Kirshnan and Stephens (1996), Levinthal and Fichman (1988) also reported on the positive association between the clients receiving a qualified opinion and a tendency to 'switching' practices.

(5) Opinion shopping

Another feature of the competitive audit environment is the practice of opinion shopping. This practice, more common in the US, refers to the search for an auditor who seems to be willing to support a proposed accounting treatment designed to help the client to achieve its reporting objectives, even in instances, when that treatment might frustrate reliable reporting (SEC, 1988). For example, the client's management may contact various audit firms asking their opinions on a particular aspect of its company financial statements. Moizer (1991) argued the effect of such practice is to weaken the position and the prestige of the existing

auditor, once the client's management can say that another audit firm would act differently in a particular case.

The nature of the highly competitive audit market results in intensive pricing practices, in time and budget pressures, and accordingly has an impact on the quality of audit work. Previous studies have investigated the effect of time and budget pressures on the impairment of audit independence. Pearson (1980a) and Ryans and Pearson (1982) found that the auditors are aware of the existence of a price competition in the auditing profession which exposes time pressure on audits. They further argued that if, as a result of the strong pressure being effectively exerted, the auditor places significant emphasis on the subjective representations of the client's management; that is likely to result in an independence conflict. In particular, the audit partners considered the price competition to be excessive. This is consistent with the findings of the Cohen Commission (1978), Adams Committee (1978) and Pearson (1980b) arguing that a highly competitive market for audit services places time and budget pressure on the auditor to the extent that the auditor is being tempted to omit the audit procedures to be performed and he/she may subjectively rely on the client's management representations without alternative evidence. Otley (1996) argued that such practice results in a lower quality of audit. When the budget seems unattainable the auditor has an inclination to perform the audit at a lower standard which is reflected in premature signing off, in the failure to follow accounting principles and accordingly, in the acceptance of 'weak' explanations from the client's management. Further, Willett and Page (1996) argued that time budget pressure might produce irregular short cuts in the audit procedures, for example by the auditor's rejection of problematic samples or by reduction of time spent on testing the transactions and balances. These findings suggest that an incidence of irregular auditing reflected in the audit procedures' short cuts is associated with time budget pressures and a particular audit firm culture, a culture which implicitly accepts the irregular short cuts in the audit procedures. Kilcommins (1997) examined auditors' perceptions of auditor independence in the UK and found, on the contrary, that the majority of respondents did not perceive the competitive audit market as having an adverse impact on the audit quality. The auditors highlighted the level of importance the audit firms attach to their reputation as a factor ensuring that audit standards would not be compromised as a result of competition. Some auditors argued that the provision of NAS encourages auditors not to reduce a high standard of audit since a poor quality audit could result in the loss of both the audit engagement and contracts for NAS.

In summary, the results from prior studies with regard to the effects of audit market competition provide conflicting results on whether or not such competition leads to the

impairment of audit independence, and whether such competition affects the quality of audit performed. Further, a consensus as to the impact of time and budget pressures on the quality of audit has not been reached.

2.4 The provision of non-audit services

The scale and extent of management services or non-audit services (NAS) has increased substantially over the last decade to the point where now they form the substantial proportion of the Big Five revenues. In 1993-94 the proportion of total fee income of the Big Five audit firms from services other than audit ranged between 55% and 81% (Accountancy, July 1994, pp. 15). Commercial pressures push the audit firms to expand to new areas, since survival on the market means finding new value-added products to sell to their clients. Barkess and Simnett (1994) examined the pricing issues associated with the provision of non-audit services and argued that an increasing number of the audit clients are purchasing other services from their audit firm, including consulting, managerial advice, and corporate functions.

Among the factors identified in the literature which might threaten the auditor's independent judgement, the provision of NAS to the audit client has been the subject of extensive debate. The literature, however, is divided as to whether or not the provision of NAS does impair auditor independence and whether it influences independent audit judgement. In particular, the question surrounding the audit firms providing NAS to their audit clients focuses on the ability of the audit firm to objectively evaluate the client's financial statements while the firm simultaneously provides management services to this client (Ezzamel et al., 1996). Mautz and Sharaf (1961) and Shockley (1982) argued that in cases when the auditor tries to fulfil both roles, audit and consulting, independence may become impaired as the result of the consultant becoming effectively a decision maker, an employee of the client or a client's advocate. On the contrary, Carey and Doherty (1966) argued that if the auditor does not participate in any final decisions of the client's decision making process and if he/she confines management services to advice, auditor independence is not affected.

'There is no objection to a firm providing advisory services to a company which is additional to the audit, but care must be taken to ensure not to perform management functions or to make management decisions. It is economic in terms of skill and effort for the [auditor] to be able to provide other services to their clients since they have already good knowledge of their business. Many companies ...would be adversely affected if they were denied the right to obtain other services from their audit firms' (CAJEC, 1995).

‘The auditor must ensure that his/her firm is not involved in the decision making process of client's management’ (European Commission, 1996).

A number of studies have investigated the impact of the provision of NAS on the perception of audit independence. In instances when audit independence is in danger of being impaired, it may have an impact on the auditor's scepticism and his/her objectivity and accordingly, individual judgement with regard to the need for detailed checking of controls and transactions may be moderated by such awareness. Some of the previous studies indicated the provision of NAS causing an impairment of auditor independence (Beattie et al., 1997). In the early stages of independence research, Briloff (1966) asked the members of the accounting profession to express their views on the provision of specific management services by the auditor as to whether or not their performance would adversely affect auditor independence (not specifying whether NAS was performed by personnel separate to those performing the audit, or the same personnel). He found that a majority of respondents perceived a duality of the auditor's function as being incompatible with the auditor's tradition and his/her independence; some respondents claimed that such a duality should be restricted and discouraged⁵. Similarly, Shockley (1981) studied perceptions with respect to auditor independence and found that audit firms which provided NAS to audit clients were considered to lose independence at a higher rate than those which did not. Shockley (1981) limited the definition of NAS to the design and installation of accounting systems. Pany and Reckers (1987) examined whether the audit performance of NAS affected loan officers' and financial analysts' perceptions of auditor independence. In their study NAS was defined as the design of internal controls and services for the purpose of improving the existing controls conducted by audit firm, but not those involved in audits (a clear distinction between personnel providing NAS and those involved in the audit was made). They used between and within subject designs. In the within-subject design, the subjects were asked to indicate their beliefs that the audit firm was independent when various levels of NAS were performed, not providing any financial or other information about the client or about the audit firm. In the between-subject design, the subjects were required to review a loan application or equity investment form and to evaluate the audit firm's independence under one of four levels of NAS performance (i.e. no NAS, NAS income set at 25%, 60%, 90% of audit fees).

⁵ The results of this study should be interpreted with caution since Briloff (1966) did not indicate how many questionnaires were initially distributed and therefore, it is difficult to calculate the response rate for that study.

The results of the study indicated that in the within-subject design, subjects perceived that NAS performance impaired auditor independence. However, in the between-subject design, the mean responses as to perceived independence did not differ regardless of whether or not NAS had been performed⁶. More recent studies also indicated that provision of NAS impairs auditor independence. Mitchell et al. (1993) argued that the provision of NAS leads to unfair competition because it abuses the monopoly of the audit function. They recommended that the auditor should exclusively provide audit services and be prohibited from providing NAS to its audit clients.

Finally, two studies which investigated the provision of NAS, examined the impact of non-audit services on the auditor's ability to resist management pressures in conflict situations. The first study was that undertaken by Knapp (1985). He tested whether bankers perceived management to be more likely to obtain its preferred resolution of the conflict situation when the audit firm provided a significant amount of NAS (the level of 40% of the audit fees), as opposed to the audit firm providing no NAS. NAS was defined as a management consulting project on the client's cost accounting system. The results of the study showed that the provision of NAS at the level of at least 40 % of the audit fees by the audit firm slightly increased the likelihood of a conflict being resolved in favour of the client, meaning the auditor's judgement was at risk of being compromised. The second study was that undertaken by Gul (1991) who evaluated the impact of NAS on bankers' perceptions of the auditor's ability to resist management pressure in the conflict situation (NAS was defined as the design and installation of a new financial and cost accounting system). Gul (1991) found stronger evidence that the auditor from the audit firm providing NAS were perceived to be more likely to resolve a conflict situation in favour of the client than auditors not providing such services. Gul (1991) argued that it is so due to the concern that the auditor from the audit firm may, in effect, become an employee of the client, or be placed in the position of auditing his/her own decisions. Gul (1991) further suggested that the subjects of his study believed that the audit client may attempt to replace the existing audit firm with a more compliant auditor, and therefore the auditor who is concerned about being replaced is seen as less likely to resist management pressure.

⁶ The results were questioned due to the suspicion of demand effects occurrence of which might negate some of the conclusions that certain variables have a significant impact on auditor behaviour. Pany and Reckers (1987) explained the notion of demand effects by the subjects awareness that they were involved in the experiment; in the 'real construct' situation they might have replied differently.

While the results of studies described above indicate an impairment of auditor independence in cases when the audit firm provides NAS to its audit clients, other studies show no such impairment. McKinley et al. (1985) examined bank officers' perceptions with regard to audit independence, provision of NAS and the reliability of financial statements. They found that respondents had more confidence that audited financial statements were free from material misstatements where the same audit firm also provided NAS. The respondents believed that NAS performance led to tighter controls. In effect, the provision of NAS did not significantly affect respondents' perceptions regarding impairment of audit independence. Similar results were provided by Pany and Reckers (1988) who investigated the effects of NAS provision on perceptions of the financial statements' reliability. They concluded that the auditor's performance of NAS exerts little, if any effect on the perceptions of the financial statements' reliability or on auditor independence. Lindsay et al. (1987) examined auditor-client relationships, and some of them dealt with the provision of NAS. They found, similarly to McKinley et al. (1985) and to Pany and Reckers (1988), that the independence of the auditor was not impaired when the audit firm was involved in NAS to the audit clients. However, they further identified that when the performance of NAS generated fee income between 25-30% of the total fees, the users of financial statements considered that the auditor-client relationship might impair audit independence.

A few studies have indicated the provision of NAS as enhancing auditor independence. In the study undertaken by Gul (1989) where bankers' perceptions of audit independence were examined, the findings indicated a positive relationship between the perceptions of auditor independence and the provision of NAS. The bankers had more confidence in the audit firm providing NAS to the client (the provision of NAS was defined as a design and installation of cost accounting systems; budget and inventory control systems were provided by a separate department within the audit firm). Similarly, the results of Goldman and Barlev's (1974) study indicated that the provision of NAS enhances auditor independence. They examined client-auditor conflict and argued that conflict was likely to arise due to the client's management pressure to present favourable results of the firm's performance to third parties. Goldman and Barlev (1974) asserted that, due to the fact that most of the consulting type services are not routine, the provision of NAS increases the audit firm's 'bargaining power', and therefore the auditor is better equipped to resist management pressure in the performance of audit duties, and he/she is more likely to retain independence.

Further, it has been argued that the provision of NAS by audit firms can be beneficial, because it might increase the auditor's knowledge about the client and thus allow him/her to perform a better audit.

'The provision of some NAS by the auditor will often assist the auditor to perform the task effectively, by adding to his/her knowledge of relevant aspects of the business affairs and given that objective of the independence requirements is to support the quality of audit services provided...a ban on the provision of other services could, therefore, be counter-productive' (ICAEW, 1995).

This positive effect of the provision of NAS to audit clients is known in the literature as knowledge spillovers. The phenomenon of knowledge spillovers is often quoted in the literature as a defence of the provision of NAS by the audit firm since it voluntarily enhances the audit firm's knowledge concerning the client's business and its management. If knowledge gained on the audit can also be used for advising client's management, the resulting knowledge spillovers increase the value of the audit and the audit fee.

Antle and Demski (1991) examined conditions affecting joint performance of NAS and the audit services. The knowledge spillover was information regarding the cost of performing audit and NAS for a particular client. Such information may have given rise to economies of scope. Support for the knowledge spillovers' assertion is provided by prior empirical research. Simunic (1984) and Beck et al. (1988a; 1988b) argued that knowledge acquired while providing NAS may 'spill over' to the audit and thus may generate productive efficiencies. In the study undertaken by Pearson (1980a), the audit firms' partners argued that NAS had a positive impact on the effectiveness of audit performance because the knowledge obtained from NAS aided the auditor in a better understanding of the clients' businesses, in making judgements concerning internal control systems, and in determining whether the financial statements were fairly presented. The findings by Kilcommins (1997) also indicated the beneficial effects of knowledge spillovers. The respondents of her study believed that by providing NAS to the audit clients, the audit firm's experience and knowledge results in the provision of better advice and that ensures a higher standard being applied to the audit; thus ensuring a more appropriate audit opinion. Beck et al. (1988a, 1988b) claimed that part of the demand for certain NAS is attributable to knowledge spillovers and to the auditor-provided economic incentives, such as the fee discounts, that represent cost savings from knowledge spillovers in joint engagements. The authors provided evidence of a positive association

between the length of the auditor's tenure and the effect of knowledge spillovers. They suggested that in a competitive market the audit firm uses a 'limit' pricing strategy and offers a fee discount so it seems unlikely that the client obtains NAS from competitors. Beck et al. (1988a, 1988b) made a distinction between recurring and non-recurring NAS; the auditor-client bonding between the audit firm and the client is associated with the recurring type of NAS. In other words, the auditor-client bonding goes beyond an individual audit engagement. They further claimed that such a bonding is perceived as an impairment of audit independence and that it could motivate the client to avoid the provision of NAS. However, the potential cost savings from knowledge spillovers are likely to mitigate the level of bonding in a competitive market since the audit firm has an incentive to pass on some of the savings to the client; the auditor offers a fee discount which represents a portion of the cost savings from anticipated knowledge spillovers in a joint engagement. Because the audit firm offers a discount, the client's decision involves a trade off between the reduction in fees and the agency costs associated with outside investment concentration, leverage etc. That trade off results from a perceived reduction in the quality of the independent audit. On the other hand, non-recurring NAS generally are single engagements. Beck et al. (1988a, 1988b) predicted that a bonding effect of non-recurring NAS is likely to be minimal or non-existent since future knowledge spillovers can be heavily discounted by a future period's uncertainty. In these cases, a fee negotiation occurs as needed, separately from the continuing, jointly negotiated contracts. Similarly, Parkash and Venable (1993) examined the impact of NAS on the level of economic bonding between the audit firm and the client and accordingly on perceived impairment to auditor independence. The results of their study suggest that the client recognises the potential for impairment of audit independence while NAS is provided on a perpetual (recurring) basis and therefore the client voluntarily seems to manage the amount of recurring NAS that are purchased from the audit firm. The results also support the implications of knowledge spillovers from joint engagements noted by Beck et al. (1988a, 1988b).

Simunic (1984) found the interdependencies between audit and non-audit services and interpreted these interdependencies as evidence

'[C]onsistent with the hypothesis that the cost functions for NAS and audit are significantly interdependent. Specifically (...) the observed relationship would arise if the production of NAS reduced the marginal cost of auditing and audit demand was relatively elastic' (Simunic, 1984).

This interpretation suggests that audit firms can provide audit and/or NAS more efficiently, applying less effort for non-audit and/or audit purchasers, and thereby, the audit firms can earn economic rents.

Simunic (1984) argued that in practice the theory of beneficial knowledge spillovers remains problematic, since knowledge spillovers vary according to the nature of NAS being undertaken. The work on systems of control, for instance, may result in the improved systems and the possible audit costs savings, but on the other hand, work on an acquisition is only likely to have a spillover effect if the acquisition proceeds. Therefore, it is important to specify the precise definition of NAS since the prior research is characterised by a divergence of opinions as to what exactly the provision of NAS does incorporate. Similar results to the effects of beneficial knowledge spillovers to those attained by Parkash and Venable (1993), Beck et al. (1988a, 1988b) and Simunic (1984) were also obtained by Barkess and Simnett (1994) who investigated the pricing issues of knowledge spillovers, and argued that the potential cost advantages to the client are likely to occur when the total costs of the audit firm jointly performing both NAS and the audit services are less than the sum of the costs when each service is performed by a different firm. These findings are supported by Ezzamel et al. (1996) who argued that the overlap in the supply of NAS and audit services by the same audit firm should ensure economies of scale and thus should affect the fee levels of joint service. Palmrose (1986) however, found a positive relationship between audit fees and NAS fees paid both to incumbent and non-incumbent audit firms (i.e. a firm other than the one performing the audit). Her findings for non-incumbent firms weaken the argument for knowledge spillovers. Since it seems unlikely that knowledge obtained by a non-incumbent audit firm from NAS would spill over to the incumbent audit firm providing the audit, she speculated that higher audit fees paid by the client who also purchases NAS might be driven by additional audit effort, since, for instance, NAS may have audit implications. Consistent with the findings by Davis et al. (1993), who suggested that although purchasers of NAS pay higher audit fees than non-purchasers, the higher fees are associated with a proportional increase in the audit effort, measured in their study as the number of audit hours.

Abdelkhalik (1990) reported that he was unable to detect interdependencies between audit and non-audit fees. These results seem to directly contrast the findings by Simunic (1984) and by Palmrose (1986). Abdelkhalik (1990) characterised the positive relation between audit and non-audit fees as counterintuitive, noting that

‘[I]t is difficult to think of economic incentives that could exist a priori for clients to pay more for the joint acquisition of two products than for the sum of acquiring them separately’ (Abdelkhalik, 1990).

In short, many of the previous studies focusing on the joint provisions of audit and NAS (Kilcommins, 1997; Trupen, 1990; Palmrose, 1986; Simon, 1985; Simunic, 1984) have reported a positive association between audit and non-audit fees, suggesting that the audit fees paid by the client who also purchase non-audit services are significantly higher than those paid by the non-purchasers. They suggested that the joint provision of audit and NAS may give rise to knowledge spillovers that could lead to economic rents. Abdelkhalik (1990) however reported that he was unable to detect interdependencies between audit and non-audit fees. Further, Palmrose (1986) reported a positive relationship between audit fees and non-audit fees paid to non-incumbent auditor, these findings weaken the argument for knowledge spillovers. Thus, the empirical results as to the impact of NAS on audit fees and whether it is the audit firm or the client who benefits from knowledge spillovers are mixed.

A consensus as to the impairment of audit independence by the joint provision of audit and NAS has not been reached in prior research. Thus, presumably, knowledge spillovers may not be of much benefit on audit. However, what is consistent is the finding that the risk of an impairment of audit independence decreases when personnel providing NAS and audit services come from separate divisions in the audit firm. Pany and Reckers (1984) surveyed financial analysts and shareholders’ perceptions with regard to audit independence in circumstances when NAS had been performed either by a member of the audit or by a separate division of the audit firm not involved in the audit. The results of that study indicate that for various types of NAS, such as recruiting, actuarial services, acquisitions assistance and redesign of accounting system, independence concerns decreased when NAS was provided by a separate division of the audit firm, and in particular when the accounting-oriented services were provided. These findings are similar to those obtained earlier by Mautz and Sharaf (1961). Effectively, Hillison and Kennelley (1988) recommended the ‘spinning off’ of NAS to a separate division of the audit firm to avoid impairment of audit independence. A similar recommendation was made by CAJEC (1995).

‘If the firm has designed or recommended any part of the system of control on which the audit relies, it may be advisable to arrange for a little or no common membership between the systems work and the audit team’ (CAJEC, 1995).

These findings are supported by a recent empirical study undertaken by Kilcommins (1997). The majority of respondents to her questionnaire study perceived a reduction in auditor independence when NAS were provided by audit personnel to the audit clients. The respondents associated their lack of confidence in auditor independence with the audit firm's dependency on such services due to the fee income. However, the threat to audit independence was significantly less when NAS were provided by a separate department of the audit firm to audit clients or to non-audit clients only. The respondents emphasised the importance of such separation as a means of ensuring that audit independence was not compromised, as well as that the reliability of financial statements was assured. In addition, the results of prior studies on the provision of NAS indicate that as the level of NAS provided decreases, the threat to auditor independence decreases too (Reckers and Stagliano, 1981). This is consistent with the later results obtained by Pany and Reckers (1983) who found that the number of cases that resulted in a total lack of confidence in auditor independence was relatively high where the provision of NAS exceeded 50% of the audit fees.

In short, prior empirical research concerning the provision of NAS has produced conflicting evidence as to the effects of the provision of NAS on the perceptions of auditor independence. Some studies indicated an impairment of audit independence (e.g. Mitchell et al., 1993; Gul, 1991). Some studies showed that the provisions of NAS to audit clients had no impact on audit independence (e.g. Pany and Reckers, 1988; Lindsay et al., 1987). Other studies demonstrated an increase in auditor independence where NAS was provided due to tighter controls (McKinley et al., 1985), increased 'bargaining power' of the audit firm (Goldman and Barlev, 1974), and knowledge spillovers (e.g. Kilcommins, 1997; Barkess and Simnett, 1994). What is consistent is the finding that the risk of an impairment of audit independence decreases when personnel providing NAS and audit services come from separate divisions in the audit firm.

2.5 The nature of material fraud and its significance for the auditing profession

Fraud in business is a growing phenomenon. Estimates suggest that on average companies suffer from fraud losses of 3% of their total turnover. KPMG Barometer (1995) shows that those charged with frauds over £100,000 between 1990-1995 fall into the following categories: 40 % are management, 44 % are external fraudsters, 12 % are employees, and 4 % fall into other categories. Other surveys suggest that the level of employee frauds is much higher, up to 60 % of the total fraud concealment, but smaller in value than management fraud (Albrecht, 1996; Thompson, 1998). Ernst & Young's survey of 100 leading British

companies has shown that 54% reported fraud over a two year period and a further 33% had experienced an unreported fraud (Ernst & Young, 1998).

Factors which have evoked changes in the business environment in the last decade in which fraud is likely to be committed include: (1) the increased sophistication and the internationalisation of commerce, (2) the consequences of the 'paperless office' where transactions are only evidenced within the computer systems, and (3) changes in management philosophy, in the business culture and in ethical standards. The internationalisation of commerce includes more sophisticated derivatives being the subject of trade through more complex financial services. Extensive use of computers introduced to some extent an abandonment of document trails which facilitate the process of money transfer, and thus makes it easier to move money quickly and/or without trace. Further, office technology enables one to forge apparently convincing evidence. The changes in management philosophy over the last decade have encouraged companies to downsize and to empower their employees, which has led to an increased vulnerability of business to fraud, and at the same time increased the incentives to individuals to act fraudulently. The principal causalities of downsizing and empowering are middle management who are highly experienced and possess the key competencies for financial control. Other consequences of the changes to the business culture are: the increased workloads, less security of employment and fewer opportunities for advancement in the new organisational structures have led to lower levels of commitment among the employees. In such a changing environment, internal controls tends to stay behind the business developments.

There is a general perception of a decline in ethical values and standards in business which has contributed to a blurring between an acceptable and an unacceptable practice for both management and employees. The decline in ethical values impacts on the auditor-client relationship since the auditor, or at least the audit engagement partner, strongly depends on the fees from the client. The balance between the auditor and the client's management seems to be 'uneven' in such a competitive market. In cases when the auditor may have suspicions about transactions, he/she seems to find it difficult to challenge management without sufficient facts due to the fear of being replaced. The client's management may, thus, provide facts which could have been fabricated over a long period of time and which put management in a strong position to deceive the auditor and to commit fraud. Against this background it seems to be increasingly important for the auditor to be alert to fraud within the client's firm and to the ways his/her clients endorse, communicate and ensure the compliance with ethical standards.

Recent surveys have shown that over 50% of the public and approximately 60% of companies' directors expect auditors to detect fraud. Estimations have suggested that between 1989 and 1994 reported fraud cost British business £2.2 billion (KPMG, 1995). In 1992, The Big Five audit firms spent in excess of ¼ of their audit revenues on audit related litigation expenditures (KPMG, 1997). Highly publicised 'audit failures' have led to a re-examination of the auditor's role. The responsibility for fraud detection has been extended among auditors world-wide⁷. As a result of notorious failures to detect fraud, litigation has had a dramatic effect on the profession, especially on the perceived quality of the audit, which seems to be rapidly decreasing. Increasing pressure to reduce fraudulent reporting has recently resulted in new laws and standards (Percy, 1999).

In the UK, in 1995 the Auditing Practices Board issued the Statement of Accounting Standards SAS No. 110 entitled *Fraud and Error* (hereafter SAS 110) which requires the auditor to plan and conduct the audit so as to provide a reasonable expectation of detecting material misstatements caused by both fraud and error. In either case, the auditor is required to plan and perform his/her work with an attitude of professional scepticism. SAS 110 states precisely

'[A]uditors should plan and perform their audit procedures and evaluate and report the results thereof, recognising that fraud or error may materially affect the financial statements'
(SAS 110, para 1).

Early in the planning stage of an audit, the auditor looks for the circumstances or the combinations of circumstances that make fraudulent reporting more likely (Finney et al., 1994). When such situations are found to exist, the auditor should design the audit programme to detect potential material misstatements. In other words, when the auditor determines that material misstatements could occur, the audit plan should reflect an increased level of professional scepticism. Under such conditions, the auditor is very likely to demand more competent evidence and/or a greater amount of evidence. Further, SAS 110 states that an audit cannot be expected to detect all errors or instances of fraudulent or dishonest conduct. SAS 110 states clearly that it is for the court to determine whether or not fraud has occurred in a particular instance. It seems to be very difficult for auditors, against this background, to distinguish unintentional mistakes in financial statements from those which

⁷ In the US, Statements on Accounting Standards SAS No. 82: *Consideration of Fraud in Financial Statements*, 1997 and SAS No. 53: *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, 1988, AICPA. In Canada, *CICA Members Handbook, Auditing Recommendation Section 5300*, 1988, and *Section 5315*, 1991.

arise from the intention to mislead and from any unethical conduct. SAS 110 provides a broad definition of fraud.

'Fraud comprises both the use of deception to obtain an unjust or illegal financial advantage and intentional misrepresentations affecting the financial statements by one or more individuals among management, employees, or third parties and it may involve:

- falsification or alteration of accounting records or other documents,
- misappropriation of assets or theft,
- suppression or omission of the effects of transactions from records or documents,
- recording of transactions without substance,
- intentional misapplications of transactions or of the entity's state of affairs' (SAS 110).

Since there is no legal definition of fraud, it may be defined as any behaviour by which one person intends to gain a dishonest advantage over the others (Abdelkhalik and Salomon, 1983). Fraud, being a generic term, embraces a variety of dishonest actions ranging from a concealment to a deception and a false accounting. Drawing upon SAS 110, Porter (1997) defines fraud to mean one of the following

- '(1) [T]he use of deception, such as manipulation, falsification, or alteration of accounting records or other documents, in order to obtain an unjust or illegal financial advantage,
- (2) intentional misstatement in, omission of amounts or disclosures from accounting records or financial statements,
- (3) intentional misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure,
- (4) misappropriation of asset or theft' (Porter, 1997).

SAS 110 also identifies certain conditions or events that are likely to increase the incidence of fraudulent financial reporting.

'Conditions or events which increase the risk of fraud and error include:

- previous experience or incidents which call into question the integrity or competence of management or other staff,
- particular financial or reporting pressures within the entity,
- weakness in the design and operation of the accounting and internal control systems,
- unusual transactions,
- problems in obtaining sufficient appropriate evidence,
- inadequate control over data in an information system environment' (SAS 110).

These factors, referred to as red flags, are likely to cause the auditor under the conditions of increased inherent risk to exercise more cautious judgements (Reckers and Schultz, 1993). Red flags consists of potential symptoms (conditions and events) existing within the company's business environment that would indicate a higher risk of an intentional misstatement of financial statements. Examples of these conditions and events are provided in Appendix 1 of SAS 110.

It could be argued that SAS 110 acts as the guidance document, significant for the auditor because it does not deny that the auditor has a duty to detect fraud. But this duty is qualified by the concept of a 'reasonable expectation of detection'.

'The detection of management fraud is neither ruled out of the audit process, because this would lower expectations and cause that audit might lose its value, nor clearly ruled in, since it would burden the auditor and would make audits very expensive' (Power, 1997, p. 25).

Fraud often goes undetected partly because of an inability to specify what it means to have 'reasonable' expectation to detect potentially material misstatements.

The unique position of management in the company often tempts managers to be engaged in fraudulent activity. Fraud committed by management is particularly difficult to detect, because the client's management is in a strong position to conceal it. The auditors' understanding of the motivations for committing fraud is an important factor in the identification of fraud. It is important to distinguish that not all fraud has a financial statement affect. The APB Working Party examined 28 most recent serious fraud cases brought before the British courts in the period 1994 to 1997. In half of the examined cases there was evidence to show that the fraud was likely to be material in the context of the client's financial statements. In all of these cases there was evidence that the client's management deliberately seemed to manipulate the company's financial results (APB, 1997b). In cases with non serious fraud examined by the APB working party, the lifestyle factors and the theft of the company's or the client's liquid assets seemed to be more important in the identification of fraud. In other circumstances, where evidence of an intent to deceive was not a consequence of individual greed, a common feature of major fraud was the client's management manipulation of accounting records to conceal a disadvantageous position at the end of the financial year. It is usually the management's expectation that any false accounting can be undone once the underlying operating problems are overcome and trading improves.

Examples of techniques applied by management to conceal fraud include:

- introducing complexity into the internal control system, the group structure, and/or transactions,
- engaging in collusive acts with employees or third parties,
- overriding internal controls,
- manipulating evidence available to the auditor,
- making untruthful representations to the auditor,
- changing the auditor sufficiently frequently, so that the auditor never gets to know the client (i.e. the auditor switching),
- influencing accounting policies, accounting estimates, and financial statements presentations,
- including unaudited entities in the group structure, so that the auditor is unable to follow transactions and cash flows around the group,
- appointing different auditors to different parts of the group to impair the auditor's understanding of the entity as a whole (APB, 1997a).

There are different theories which assist in an understanding of fraud: (1) differential of opportunity theory, (2) theory of concealment, (3) theory of deviation, and (4) theory of minimal and general collusion (Comer, 1998). The differential of opportunity theory suggests that individuals have the opportunity to commit fraud against the employer, third party or government. This opportunity is governed by three factors: the access to accounts/assets or computer systems, skill to identify the opportunity, and time to commit the fraud. Theory of concealment suggests that in order to conceal or assist a theft, the fraudster deliberately introduces confusion. This confusion may divert attention from any shortage, disguise, confuse or delay the discovery or prevent identification of the theft. The fraud flows an incremental pattern, and is limited only to the fraudster's greed, and accidental or contrived opportunities. Theory of deviation implies that fraud being a deviant behaviour, places the fraudster under considerable strain to conceal his/her guilt which results in plausible deviations from acceptable behaviour and underlying procedures. These changes of behaviour are a first sign of fraud concealment. Theory of collusion suggests that collusion occurs under two conditions: the provision of necessary opportunities, resources and skills to commit fraud (minimum collusion), or share of the benefits of low skill frauds among maximum number of individuals (institutionalised fraud or general collusion).

Due to liability issues, there is pressure on audit firms to find the ways to improve the effectiveness and the quality of audit with a respect to fraud discovery. Audit firms have been concerned with the developments of internal procedures for detecting fraud. There were early

attempts made to develop red flags and risk analysis. (Bologna, 1993; Sorensen et al., 1982). Further, audit firms frequently advertise and promote their forensic audit capabilities. It appears therefore that the techniques and expertise to detect corporate fraud are available within the audit firm, but rather than using them to satisfy the public's expectations of the auditor establishing either absence or presence of fraud as part of financial audit, this expertise is offered to management as an additional service, as the provision of NAS. Currently the Big Five audit firms provide additional, chargeable special fraud audits, extra to the normal statutory audits. While the financial audit is intended to uncover deviations and variances from accounting standards, the fraud audit is looking behind and beyond the transactions. Auditing for fraud, in comparison with financial audit, requires more of an intuitive process than an analytical method.

'A particular process to look for the exceptions and oddities, the things that do not seem to fit in an organised scheme of things because they seem too large, too small, too frequent, too rare, too high, too low, too good to be true, too extraordinary, too many, too few; it involves odd times, odd places, odd hours, odd people, and odd combinations' (Bologna, 1993).

Some techniques of forensic auditing include: (1) critical point auditing, (2) job sensitivity analysis, (3) vulnerability charts, (4) invigilation and created checks, (5) observation, (6) undercover investigations and informants, (7) business intelligence, (8) spot checking, and (9) criminal targeting (Comer, 1998). Critical point auditing, through the examination of accounts and records, can identify the symptoms of manipulations. The most common of examination methods include analysis of trends⁸ and specific tests⁹. Job sensitivity analysis identifies all job positions in the client's company with the objective of preparing report showing approved access to accounts, inventories, computer systems via organisational charts, job description, and authority schedules. This analysis highlights high-risk jobs with regard to concealment of fraud. Vulnerability charts is a schedule of risks arranged in order of probability, it involves identification of assets at risk, effectiveness of controls, possible methods of fraud and possibilities for conversion. Invigilation and created checks are used to detect or measure the impact of fraud and to establish genuine operating losses. Invigilation can be carried out in any business, but is expensive and requires staff with a high level of

⁸ Historical, proportional and inter-company analysis concentrates on examining reasonableness of entries in accounts and involve comparison in performance between branches and over time. Filters are based on final accounts, trial balances and budgetary records. These tests are subjective (Comer, 1998).

⁹ These tests focus on high risk areas of fraud, such as purchases, disbursement cheques, sales, marketing, incoming cheques, stock, asset, inventories, payroll, statistical records etc (Comer, 1998).

expertise. Invigilation needs to concentrate on physical movement of goods or assets. Observation involves monitoring physical behaviour and performance and comparisons with records. Undercover investigations and informants are aimed to gain by covert means information that can be used and proved in a conventional open investigation. Business intelligence refers to all legal methods of obtaining information on competitors and competitive intentions to ensure that supplies and sales are not prejudiced by dishonest competitive practices. Spot-checking is a special management verification of particular commercial circumstances or transactions (Comer, 1998). Thus, to 'see' potential fraud the auditor needs to be capable of transcending the traditional structure of 'risk-based' auditing.

Bologna (1993) claimed that the fraud audit is more of an art than a science. The question therefore arises to what extent the fraud detection function is currently provided through the statutory audit? As Humphrey et al. (1993) noted, the auditor's obligations to fraud detection are increasingly appearing to be framed by the audit firms as a service to the client's management rather than a check on the client's management. They pointed out the need for a legal clarification of auditing responsibilities with regard to fraud since currently the auditor may not be sufficiently remunerated to either detect major frauds or to accept the responsibilities with this regard under the existing framework of 'a reasonable expectation' of detecting material misstatements resulting from fraud and error.

The time and costs involved in unravelling fraud and in interpreting the 'economic text' of all transactions are enormous. Therefore, for the financial audit, the question is what level of work can be performed before the costs outweigh the benefits derived from additional audit hours prescribed in order to reveal fraud, and what is the cost-benefit optimum point in the cost-benefit equation? All audits involve judgements about the extent of work to be carried out. One of the important factors in those judgements are the audit fees. The fees affect the number and the value of transactions and balances that can be tested. Accordingly, the auditor cannot always be expected to find (immaterial) fraud where fraud is not of sufficient size to attract the attention of sample tests.

While conducting an audit, the auditor must be aware of a right balance between the use of analytical procedures and the control assessment. Analytical procedures can often mislead the auditor and give a false assurance in cases when the client's management is engaged in fraud, where the financial results are likely to be manipulated to bring them into line with expectations or to cover up the losses in order to avoid more detailed scrutiny by the auditor (APB, 1997b). Aside from the substantive verification of transactions and balances which puts emphasis on gaining evidence directly from external sources, there is a need to focus an

audit on the assessment of the client's control environment and on a review of the client's anti-fraud policies. The auditor considers a controls reliance approach to consider the types of anti-fraud controls being followed by the client and to assess their adequacy. It also allows the auditor to draw attention to the risks of fraud and any weaknesses in mitigating existing controls. There are certain dangers the auditor is exposed to in the control approach; one of the main difficulties is that fraud is often prescribed to a breakdown in the systems, but in fact systems only work as far as they envisage fraud. The first time fraud occurs, it is likely to break through the system of controls if the fraud concerned was not contemplated when the control systems were designed. Another important limitation of the systems of control in relation to fraud arises from the ability of the client's management to override control procedures. The auditor's reliance on controls is most likely to be misplaced in cases where the client's management is dishonest and/or committed to fraud. Kinney and Felix (1993) claimed that current practice in assessing the control environment consists of an overemphasis on management's representations.

The main research effort with regard to fraud audit has been directed to the red flags approach, to the identification of the circumstances in which fraudulent activity is more likely to take place, and to the indicators themselves suggestive of such activity. Heiman-Hoffman et al. (1996) examined the perceptions of practising auditors concerning the relative importance of common fraud flags. In a survey, auditors were asked to rank thirty most important warning signs concerning fraud. The auditors ranked client's management dishonesty as the most important factor with respect to risk assessment concerning fraud. They also viewed as particularly risky those clients who placed an emphasis on meeting the quantitative targets and those who were engaged in the practices of opinion shopping. Further, auditors perceived a weak control environment to be another very important sign with respect to potential fraud. On the whole, auditors perceived the attitude factors to be more important warnings signals of fraud than the situational factors. Thus, dishonest, aggressive and unreasonable attitudes of the client's management were considered more significant fraud signals than economic and environmental conditions of the client's company.

Albrecht et al. (1980) examined the fraud perpetrators in the US and Canada. The results of this study were partially reported by Albrecht and Romney (1981) who suggested two types of auditor reactions to the increasing problem of management fraud. One way of preventing additional exposure to clients with fraudulent activities was to screen new clients intensively. The second proposed approach was to pay much closer attention to situational pressures and opportunities experienced by management at both the work place and in their personal lives,

by for instance the means of a red flags checklist. This validates the studies undertaken by Pincus (1994) and Krull et al. (1994) who concluded that insensitivity to red flags is a common reason why fraud goes undetected. Similar findings resulted from the study of Sorensen et al. (1982) suggesting that in order to increase the likelihood of detection of management fraud, the formal and integrated approach of fraud flags usage should be adopted. However, they did not concentrate on the integrated model, but instead upon one specific group of red flags, those associated with audit problems relating to economic and financial pressures. By means of ratio analysis the authors attempted to identify those ratios which are the best indicators of fraudulent behaviour. Wallace (1991), commenting on Sorensen et al.'s study (1982), pointed out the particular weakness of relying on ratio analysis to detect cases of financial distress as an indicator of situations in which fraud is likely to occur arguing that fraud may result in the manipulation of ratios to make them appear healthier. Pincus (1989) examined the efficacy of a red flags questionnaire for assessing the risk of material fraud by the Big Five audit firms. Two variables were manipulated in the experiment - the evaluation of a fraudulent case or a non-fraudulent case and the use or non-use of the red flags questionnaire. The findings suggest that the red flags questionnaire users demonstrated increased comprehension and uniformity in the acquisition of indicators of potential fraud in comparison to those who did not use a questionnaire. However, there was no significant difference in the assessed risk of fraud by the questionnaire users and non-users for a non-fraud case. Further, the red flags questionnaire was dysfunctional in the fraudulent case. The source of dysfunction considered the possible failure of the red flags questionnaire users to assess all relevant clues and an overemphasis on one set of information clues over another set. Pincus (1989) concluded that the red flags questionnaire did not significantly improve fraud risk assessment.

Although previous studies indicated limitations of the red flags approach in fraud detection, the lack of awareness of the warning signs was frequently cited as a cause of audit failure with respect to fraud discovery (Heiman-Hoffman et al., 1996; Krull et al., 1994, and Pincus, 1994, 1990). There are certain costs associated with extended audits especially in instances when they are conducted due to significant red flags' presence which suggest fraud existence. However, the planning of an extended audit when fraud does not exist reduces audit efficiency and results in over-auditing. This suggests that it may not always be in the audit's firm best interest that the auditor 'over-react' to certain fraud flags, since they are seen as merely indicative of potential problems (Krull et al., 1994).

Prior research in auditing has recognised the importance of judgement, in particular at the planning stage of the audit. The following chapter is devoted to a discussion on audit

judgement and decision making. In the planning stage of the audit, the analytical review procedures involve mental representations, hypotheses generation, and information search and hypotheses evaluation; critical steps in the identification of potential fraud existence (Koonce, 1993). In this stage, there is a need for the auditor to assess specifically the risk of misstatement arising from fraud and to distinguish that from the risk of misstatement arising from error (SAS 110)¹⁰.

Since the auditor's primary concern is with material misstatement, rather than with fraud, much of prior research focused on error. There were few previous studies on the improvement of the auditor's judgement with respect to fraud detection. Bernardi (1994) examined the influence of the client's integrity and competence, as well as the cognitive styles and moral development of the auditor on fraud detection. He found that, in general, the auditor is insensitive to the initial information provided by the client being concerned with the client's integrity and competence. He further claimed the significance of the ethical beliefs of the auditor as well as the significance of the prior beliefs concerning fraud existence in fraud detection. Peow Ng et al. (1996) examined the factors which impact on the auditor's ability to generate hypotheses concerning fraud in the planning stage of the audit. The factors they investigated included the level of fraud risk, the availability of the client's management representations, the auditor's experience and the auditor's prior beliefs of fraud. The experiment consisted of a case study where the subjects were asked to list potential causes which could explain the changes in two years' financial ratios. Two factors were manipulated; the level of fraud risk by varying the client description in the case material across the groups and the availability of the client's management representations. Over-reliance on the client's management representations was one of the major reasons the auditor failed to detect fraud in the experiment. The authors suggest that it could be attributed to the interference effects of inherited hypotheses based on representations received from client's management in the hypothesis generation process¹¹. The interference effects are likely to occur when a focus on the explanations results in the failure to consider other alternative explanations. The previous studies generally indicate that auditors are susceptible to interference effects (Asare and Wright, 1995; Church and Schneider, 1993; Anderson et al., 1992; Bedard and Biggs, 1991).

¹⁰ In the US, Auditing Standards already require this assessment (SAS 82, SAS 53, AICPA).

¹¹ A phenomenon identified in psychology by Manning (Roediger et al., 1992; Nisbett and Ross, 1990); there were few studies on hypotheses generation in auditing (Asare and Wright, 1995; Koonce, 1993; Libby and Frederick, 1990).

For instance, Asare and Wright (1995) found that the receipt of non-misstatement management representations received by the auditor significantly reduces the number of plausible hypotheses generated. This is consistent with the finding by Koonce (1993) suggesting that the auditor tends to overweight an inherited hypotheses so as his/her ability to consider alternative hypotheses is inhibited. Prior research suggests that the interference effects of an inherited hypothesis seem to be contingent on the nature of an inherited representation (misstatement or non-misstatement), as well as on its source (representation obtained from the audit superior or the client's management) (Koonce, 1993). Peow Ng et al. (1996) examined whether or not the auditor's ability to generate fraud hypotheses is affected by the interference effect of the client's management representations when the risk of fraud is increased. In cases where management fraud is involved, the risk of receiving untruthful information is increased. In such instances, the ability to overcome the interference effects of an incorrect inherited hypothesis is particularly crucial to audit effectiveness.

Peow Ng et al. (1996) found that the auditors were more likely to generate fraud hypotheses when the fraud risk was increased, with 33% of the subjects generating fraud hypotheses compared to only 9% for the lower fraud risk treatment groups. Peow Ng et al. (1996) claimed that the generation of fraud hypotheses might lead to an inefficient audit when there is no evidence to suggest that the potential fraud exists. However, the finding concerning the auditor's ability to generate fraud hypotheses being sensitive to the level of fraud risk remain arguable, since 67% of the subjects in the higher risk fraud treatment group failed to generate fraud hypotheses despite the presence of fraud indicators. In addition, the authors found that the ability to generate fraud hypotheses was positively associated with the auditor's prior beliefs of fraud. These findings suggest that the auditor's effectiveness in fraud detection could be improved by increasing his/her alertness and sensitivity to the existence of fraud indicators.

Concerned with the need to improve the quality of audit with respect to fraud detection, Davidson (1994) suggested a change in the audit approach. He suggested a switch from post-fraud identification, such as documenting a proof of fraud to a concentration on prior beliefs concerning fraud existence. Based on the postulate regarding an emphasis on prior beliefs concerning fraud in the audit, Sullivan (1993) pointed out two directions for change in an audit approach, that is frontal assault and approach from the side. A frontal assault approach claims the need for more detailed testing and larger samples of transactions and balances in cases when a prior suspicion of fraud exists. This strategy focuses on finding the suggestive evidence of potential malpractice. That approach, however, causes a significant increase in the cost of audit. The approach from the side is based on the processing of information in the

manipulated environment of the client and emphasises the use of perception and knowledge in the evaluation of the risk of fraud. Johnson and Grazioli (1993), following the same argument, invoke methods based on cognitive science's success in fraud detection, in other words solving problems through reasoning rather than through experience (e.g. make use of the behaviour of the client's management to recognise their intentions and their goals). Huckenbrack (1993) suggested the development of fraud risk engagement tools to allow a firm's cumulative expertise to be available to the auditor at the initial stage of the audit. Power (1995) however argued that the use of expert systems based on aggregated expertise causes a preoccupation with the tools themselves and leads to an underestimation of the subjective judgement of the individual auditor.

On the whole, the previous studies on fraud have emphasised the importance of subjective reasoning in the audit judgement processes and decision making.

2.6 The auditor in the context of fraud recognition

Through the auditor's use of subjective probabilities, trust of the client is built explicitly into the audit risk assessment. The level of the audit risk assists in a determination of the amount of time spent on the audit, while inherent and control risks (and by default detection risk) are used to govern the distribution of time among tests of controls, analytical procedures and other substantive tests. Trust, however, appears to go beyond cognitive calculations of risk. There is an affective, unidentified component to trust that potentially influences the auditor's evaluation of both inherent and control risk and thereby determines the audit procedures. This unidentified portion of audit judgement is associated with the auditor's scepticism. The auditor should be inclined to exhibit an increased level of professional scepticism when evidence suggests a higher level of fraud risk. There is no substitute for healthy scepticism and alertness on the part of the auditor when it comes to possible material fraud situations (Ziegler, 1980).

The mentality of being dependent on the client through fees is one of the most significant perceived factors which leads the auditor to exercise an insufficient level of scepticism. An APB survey (APB, 1997b) resulted in possible explanations of how the individual scepticism of the auditor is undermined; these include circumstances when:

- the auditor wants to assume that things are right and prefers to put fraud out of mind,
- there is a close client-auditor relationship,
- financial audits are treated as a loss leader to the provision of NAS,
- there is a lack of fraud experience with an 'it will not happen to me' approach,

- there is a lack of understanding of the significance of fraudulent transactions in cases when they have been identified,
- the appointment and remuneration of the auditor by the client seems to militate against scepticism.

A particular importance to the lack of auditor independence, leading to scepticism being undermined has been the provision of NAS and limitations in evidence resources available to the auditor. This implies that the auditor is particularly vulnerable when confronted with a fraudulent client. In instances when the audit firm provides other services to their audit clients, there is a concern that the auditor may not be sufficiently independent and is likely to fail to conduct a proper audit in accordance with auditing standards. In addition to economic forces, the auditor is exposed to internal pressures within the firm he/she works for because of excessive workload as well as pressures from NAS partners. However, the auditor is often reluctant to own up to difficulties on the audit as it is seen as anti-cultural with the audit firms. Thus, a preoccupation at work may influence the auditor in a way that he/she is likely to reduce the level of applied scepticism. Further, Moizer (1995) pointed out the importance of the stress associated with the auditor's assessment of competence and integrity of the client's management. Whether or not to disclose information with potentially hurtful consequences to the client and probable negative consequences for the profession, is always under question. In practice, there is no place for the auditor who finds conflict between the recommendations of the profession and his/her own conscience.

Increasing pressure to reduce reporting has recently resulted in new laws and standards. Changes in business environment and growing litigation created a demand on audit firms for additional regulations in the forms of standards and procedures (Percy, 1999). The notion of professionalism in auditing has been recently equated with the standardisation and regulation of conduct (Hopwood, 1998) where operational procedures of auditing practice express a particular manner of making things auditable (Grey, 1998). Further, performance of the audit firm is continuously assessed by the profession and by the audit firm itself in terms of the process and compliance with that process (Hatherly, 1996). In such an environment, auditing standards require the auditor to plan and conduct the audit so as to have a 'reasonable expectation' of detecting material misstatements (SAS 110).

Facing the potential weaknesses from audit procedures the auditor must decide how to design and perform the audit applying a great amount of professional scepticism to individual judgement.

The auditing literature evokes that in order to adopt a more sceptical approach to audit work the auditor should:

- develop the understanding of the business and challenge hypotheses which underline client's business activities and company results,
- look more critically at evidence available when it appears not to support the facts,
- be prepared to change figures in financial statements and seek to disprove them rather than to prove them right. However, the auditor should not assume that people run business dishonestly as it is not then possible to carry out an audit within reasonable cost limits. Thus, there must be certain level of reliance on the client's management (APB, 1997b).

Fraud awareness needs to be a part of the audit judgement process in order to secure the quality of audit services. For that awareness to be present in audit judgement (i.e. the awareness of the possibility of intentional misstatements) requires from the auditor a better understanding of the exposures he/she may encounter in the decision-making processes and of their implications. Once these encounters and implications are identified, the auditor may transcend pragmatic compliance with the structure of the audit process by activating an independent 'way of seeing'. The reconstruction of the operational sense of independence should allow the auditor to transcend the standard format of 'risk-based' auditing.

2.7. Summary

This study looks at audit judgement processes as a means of seeking a deeper understanding of the auditor's ability to maintain his/her desired state of mind in decision-making processes. Independence of audit judgement is assumed to consist of two components; that is, independence of thought and independence from the client. Independence of thought is derivative of Power's (1997) definition of operational independence while independence from the client relates to apparent independence. Operational independence relates to the restrictions the audit firms impose on audit judgement, in particular with regard to programming judgements. The standard format of the audit process, propagated by audit firms, moderates the auditor's capability to feel free to decide the scope and the character of the audit methodologies and techniques. Hence, operational independence implies the individual capacity to freely determine the scope of audit procedures. The structure of the audit process (standard format of 'risk-based' auditing) puts independence of thought at risk (i.e. operational independence), while the power of the client over the audit fees puts at risk independence from the client (i.e. apparent independence). The preoccupation with independence in appearance somewhat precludes academic debate with regard to operational independence, i.e. the capacity of the auditor to freely decide the scope of audit and audit procedures.

This chapter discussed the issues associated with the impairment of audit independence concerning the auditor's ability to withstand the client's pressure (Kilcommins, 1997; Ezzamel et al., 1996; Barkess and Simnett, 1994; Mitchell et al., 1993; Abdelkhalik, 1990). While the audit firm provides NAS to its client, the individual judgement of the auditor may be moderated and/or even compromised (the conflict of interest arises when the auditor is faced with suspicion of the client's management fraud, at the same time being aware of his/her audit firm providing NAS to that client). Provision of NAS defines the service of a managerial advice or consultation concerning a particular aspect of the client's company, for example a design and implementation of internal control systems. The existence of NAS opportunism and the risk of possible fraud represent the 'micro-structure' of independence; in such instances, the client's management may exert power over the auditor by manipulating the explanations in a way so to deflect the auditor from consideration of fraud. In consequence, the auditor may accept given representations without sufficient facts because of the fear of being replaced and not wanting to challenge or upset the client's management. Hence, in cases when NAS are provided to the audit client, the potential impairment of auditor independence may diminish the level of independence in the auditor's judgement and in the recognition of fraud. The question is whether the auditor is able to see the 'big-picture' when the audit task environment is obfuscated by the provision of NAS and audit process is embedded in a standard format of 'risk-based' auditing.

Prior research in auditing recognised the importance of judgement, in particular at the planning stages of the audit process; that is, when the auditor applies subjective reasoning to assess the nature and significance of misstatements. Any audit, when there is a suspicion of material fraud is as much an intuitive process as an analytical method. Fraud awareness needs to be centred in individual decision-making. To 'see' fraud, the auditor needs to be able to expand his/her independent judgement beyond a standard format of the process and transcend the influences of other opinions, either from the client's management or from within the audit firm. The following chapter discusses in detail the importance of audit judgement and decision-making.

CHAPTER 3

Dynamics between professional judgement and structure in the audit process

3.1 Introduction

Historical conditions for the demand for auditing imply that when economic resources are entrusted, human nature is assumed to be untrustworthy and in need of some kind of check. Societal influences shape the norms of conduct in different organisations and define which aspects of accountability have to be subject to the monitoring of audit. The standards of acceptable behaviour derive from a societal value system and from the sanctions imposed by the changing socio-economic environment. In this context, the concept of audit oscillates around the meaning of a control mechanism for monitoring business conduct and performance.

Interpretations of the operational audit concept, however, constantly evolve. These interpretations are dependent upon societal needs and changing circumstances of ethical standards, and determine the evolution of audit. Flint (1988) argued that the audit function is perceived as required in instances where there is a duty of accountability between two parties and that an audit is the means by which accountability is ensured. He argued that in instances where there is an audit of any description, there is a relationship in which one party owes a duty of accountability of some kind or another to others¹. Since audit is an integral part of the process of accountability, the existence of a requirement is seen as a primary condition of audit. The concept of accountability exposes the wholly utilitarian function of audit. The practical usefulness of audit has evolved in response to a perceived need of individuals or groups in society who seek information and/or reassurance about the conduct or performance of others, in which they have acknowledged legitimate interest. Audit exists because the interested individuals and/or groups are unable to obtain for themselves the information or reassurance they require. Thus, audited financial statements have an added utility; the audit benefit – envisaged as reassurance and comfort – is frequently intangible, where the ‘common sense’ of audit practice contributes to the production of socially demanded assurance. In a way, since the audit role emphasises the production of comfort, there is an institutionalised need for auditing not to be too ‘successful’ in finding problems and in producing discomfort by reporting these problems. Hence, the underlying philosophy of audit is a social control mechanism for securing accountability (Flint, 1988) and producing comfort (Power, 1997). Standards of accountability of the conduct, performance and achievement of quality of information are set for those who are accountable (e.g. directors of organisations are accountable to shareholders).

¹ The principles of audit may be universally applicable although the particular applications, standards of specific performance and recognised audit practices are unlikely to show uniformity due to differences in traditions, cultures, socio-economic development and the particular national characteristics, which resulted in different needs for regulatory mechanisms, corporate structures and business environments (Flint, 1988).

Accounting and auditing have come to be regarded as socially constructed (Miller, 1994, p. 1); the effect of reciprocity becomes entangled in heterogeneous practice and procedures embedded in the philosophy of social science, the dictates of financial markets, managerial discourses and the needs of society. Auditing exists because of the way our society is and the way individuals are constituted. The high level of competition and socio-economic change in the last twenty years has engendered an emphasis on the commercial vision of reality as a dominant ideology with facilitating, legitimisation processes (Birkin, et al., 1999). Trust in the auditing profession becomes institutionalised and bestowed on the auditor; this trust differs from the trust of ordinary individuals. Trust is increasingly 'vested, not in individuals but in abstract capacities...the modes of trust in modern institutions rest upon vague and partial understandings of their 'knowledge base'' (Giddens, 1990, pp. 26-27). Embedded in such an environment, the auditing profession acts upon individuals, entities and processes to transform them and to achieve specific ends. The profession, therefore, affects the world we live in and the types of social reality we inhabit.

In simple terms, the output of the audit process is an opinion; the effect of this opinion is to enhance the credibility of the audited statements (Power, 1997, p. 16). The auditor's role in the economic order is to judge and to attest to the validity of the financial statements, which contain a stylised interpretation of the financial health of the company. (Pentland, 1993). The auditor in his/her judgmental processes constructs the interpretations of accounts in order to reassure the public that the examined statements are trustworthy.

This chapter discusses the importance of judgement in the auditing profession. The remainder of the chapter is organised as follows. Firstly, underlying philosophies and applied meanings of judgement in the profession are discussed. Secondly, a literature review on audit judgement and decision making studies is provided. This review demonstrates that prior research has focused heavily on quantitative assessments of the auditor's performance and has lacked a conceptual framework of the auditing milieu in which judgements are subject to formation and deformation. Thirdly, the role of knowledge and its systematisation in auditing are presented. Finally, drawing upon the concept of audit as a social construct and locating the audit judgement milieu as being embedded in wider structural and organisational contexts, the theoretical framework of this study is defined.

3.2 Underlying philosophies and the operational role of judgement in auditing

Judgement is seen as a central activity of audit, since the auditing role is to judge and to attest the validity of financial statements providing reassurance for its readers. Professional judgement implies a meaningful choice, and involves difficult and complex issues and consequences that are significant to those concerned (Gibbins and Mason, 1988). AICPA (1955) stated that judgement is the most important factor in the making of an audit. Mautz (1959) argued that judgement must

inevitably play a major role in auditing. Gray (1990) claimed that the audit is an essentially imprecise and impressionistic process where professional judgement holds the central position. Solomon (1995), on the basis of the review of auditing standards in the US and the analysis of recent court cases, concluded that judgement pervades virtually every aspect of contemporary financial statements audit.

Judgement runs right the way through any audit. Audit process is a process of measurement of actual business conduct and performance and of its comparison with existent standards. Table 3.1 below provides a list of judgement activities related to the audit process identified by Bamber et al. (1995) and the types of judgements to which these activities lead. As can be seen in Table 3.1 judgement at any stage of the audit process incorporates the estimation of outcomes and the evaluation of the consequences of these outcomes, leading to a decision or to a choice among alternative decisions. In the course of planning and executing any audit, the auditor is required to make decisions on how to proceed and how to make choices among alternative courses of action. He/she must decide how to conduct the investigations, the scope, the extent and depth of the examination and the volume of evidence to obtain. Finally, he/she must conclude whether the financial statements do show a *true and fair view*. Solomon (1995) further noted that audit judgement not only relates to the audit process itself, but is also involved in pre-engagement activities - including the client's selection and audit tendering and in post-engagement activities - including decisions after the report had been issued in instances, when the omission of required procedures was discovered. In short, audit judgement in any stage of the audit process encompasses sequential steps: (1) definition of the task, (2) obtaining information from both internal memory and external sources, (3) identification and evaluation of possible alternatives to the problem, and (4) execution of the decision (Rennie and Gibbins, 1993).

It is not possible either to establish precise normative criteria against which to assess these judgements at different stages of the audit process nor to obtain wholly persuasive evidence on the matters of concern. Akresh et al. (1988) claimed that the process of obtaining and evaluating evidence is a complex and little understood process in itself. Ashton et al. (1988) argued that the audit decision is determined, not only by evidence, but by the nature of the audit process, the characteristics of the auditor and by the audit environment. Section 3.5 is devoted to a discussion on the interrelated components of audit judgement.

In the auditing profession the words *judgement* and *professional judgement* are used interchangeably. The essence of a profession is that a high degree of judgement is required in its practice.

Table 3.1
Judgement within the audit process

Judgement activities	Resulting judgements
Establishing materiality	Accounting materiality. Audit materiality. Acceptable business risk.
Identifying important audit objectives and assertions	Important audit areas. Important transactions streams and balances. Important financial statements assertions.
Assessing the inherent risk	Implications of the client environment for identification of potential audit concerns, focuses of audit attention, and control structure. Inherent risk assessment for financial statements assertions.
Evaluating internal controls	Potential for improved audit efficiency based on assessing control risk as less than maximum. Key control risk for financial statements assertions. Control risk for financial statements assertions. Weaknesses in controls.
Developing an audit strategy	Reliance on tests of controls. Potential for different audit approaches (e.g. suitability of analytical procedures as substantive evidence, circumstances favouring statistical or non-statistical audit sampling, or other forms of detailed tests). Emphasis on balances or on transaction streams. Identification of strategic assertions.
Generating the audit programme	Selection of an appropriate combination of specific audit procedures and determination of scope and timing of application.
Selection and evaluation of analytical review procedures	Particular procedures to be applied, data to be used, relevant formulas and calculations. Development of expectations. Identification of significant fluctuations. Formulation and corroboration of explanation of fluctuations.
Evaluating of the results of testing	Conclusions on the results of specific audit procedures in relation to their objectives and to the results obtained

Table 3.1 (Cont.)

Judgement activities	Resulting judgements
Considering the materiality of unadjusted audit differences	Consideration of the nature and amount of unadjusted audit differences individually and in aggregate in relation to their potential impact on users of the financial statements. Decision as to whether to press for adjustment by the audit client, or to accept the differences as immaterial.
Determining the going-concern basis	Whether the client can reasonably be expected to continue in operation for forthcoming year.
Applying accounting and auditing standards	Identification of relevant accounting and auditing standards. Determination as to whether or not such standards have been appropriately applied in the light of client circumstances. Identification of appropriate courses of action in cases where standards have not been correctly applied.
Applying Code of Professional Conduct	Determination as to whether auditor behaviour is acceptable within the dictates of professional requirements and ethical principles.
Selecting an appropriate audit opinion	Whether the financial statements are fairly presented.

(Source: Bamber et al., 1995)

The value associated with the audit derives from the professional judgement of the individual auditor and is supported by the more abstract, collective judgement of the profession as a whole, encompassed in professional standards.

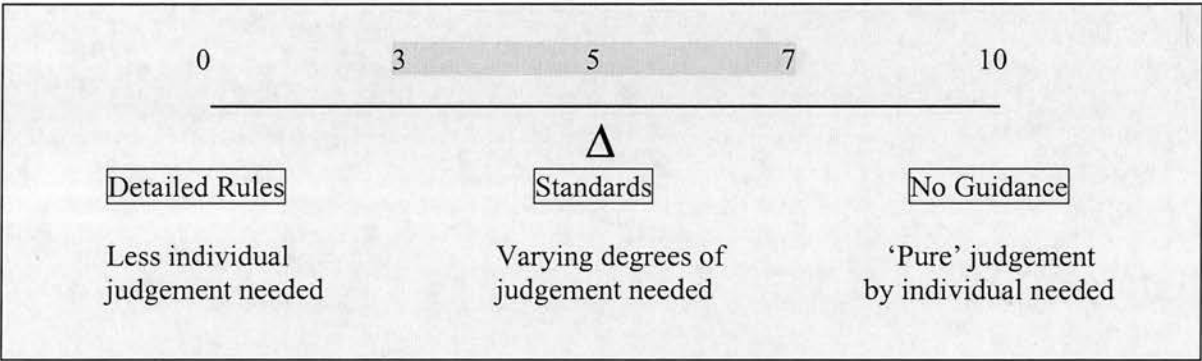
Professional judgement, therefore, takes place in the context of professional standards. By communicating the expertise of the profession, the standards support the exercise of judgement by the auditor.

‘Professional judgement in auditing is the application of relevant knowledge and experience, within the context provided by auditing and accounting standards and rules of professional conduct, in reaching decisions where a choice must be made between alternative possible courses of action’ (CICA, 1995).

‘Standards are principles to guide and support quality and provide the basis for sound judgements’ (APB, 1994, p. 5).

A particular feature of the body of knowledge that supports auditing is its codified nature. Codified auditing standards are drawn upon audit judgement – a central activity of the audit process. The illustration of audit judgement in the context of standards is presented in Exhibit 3.1. A ‘0’ indicates that the auditor needs to exercise less judgement because the profession has issued detailed rules and guidance of conduct. At the other end of the scale, ‘10’ indicates a complete absence of rules. In other words, instances where there is no guidance on what should be done may be called ‘pure’ judgement situations. Professional judgement should be distinguished from regulatory compliance with the product based on a prescribed procedures, indicated by ‘0’, and from a purely judgmental product, based on experience alone or a creative activity, indicated by ‘10’. In situations, where there is no standards and guidance, indicated by ‘10’, creativity may involve a radical departure from the accepted norms. Between the two extremes the mean of ‘5’ judgement is meant to be exercised within the context of the existing standards and guidance.

Exhibit 3.1
Assessing the need for judgement



(Source: CICA, 1995)

The existence of standards requires considerable judgement on the part of the individual auditor in the processes of interpreting the situation and applying standards while conducting the audit. The existence of standards, however, does not always solve a particular problem; the standards are not fully consistent, clear, comprehensive or up to date (CICA, 1988). When exercising professional judgement in a financial statement audit, the auditor makes decisions with respect to financial reporting. Accounting, auditing and ethical standards are inseparable from the financial reporting

judgement process. A definition of professional judgement in financial statement audit applies to every stage of the audit process.

‘The process of reaching a decision on a financial statement reporting issue can be described as professional judgement when it is analytical, based on experience and knowledge (including knowledge of one’s own limitations and of professional standards), prudent and carried out with integrity and recognition of responsibility to those affected by its consequences. Such professional judgement is likely to be most valuable in complex, ill-defined, or dynamic situations, especially where standards are incomplete, and should normally involve consultations, identification of potential consequences and documentation of the analytical processes leading to the decision’ (CICA, 1988).

The above definition describes the circumstances where professional judgement would be most valuable depending, to a large extent, on the nature and complexity of the audit problem. As mentioned above, professional judgement takes place in the context of professional standards, reflecting the judgement of the profession as a whole. On the other hand, by referring to professional standards, the definition of professional judgement incorporates the concepts of auditor independence, objectivity, and integrity. Respectively, by communicating the profession’s experience, the standards ought to support the exercise of independent judgement by the individual auditor.

In the British tradition, judgement in audit is more of an individual process which encompasses the experience of the profession. The auditor is required professionally to follow the standards and guidelines, and where other pronouncements are not definite, the auditor is expected to exercise his/her individual judgement in determining the audit procedures and in forming an opinion. SAS 100: *Objective and General Principles Governing an Audit of Financial Statements* states that

‘[I]n undertaking an audit of financial statements auditors should...carry out procedures designed to obtain sufficient appropriate audit evidence...so as to determine with *reasonable confidence* whether the financial statements are free of material misstatement’ (para 2, APB, 1995).

Materiality in financial statements audit remains very much a matter of individual judgement of the auditor applied with the *reasonable confidence*. Qualitative indicators and quantitative criteria seem to be useful as aids to professional judgement, but audit evidence reliance must be placed on the knowledge, skill and experience of the individual auditor. SAS 220: *Materiality and the Audit* explains that

‘[T]he assessment of what is material is a matter of professional judgement and includes consideration of both the amount and nature of misstatement...Auditors apply judgement taking account of materiality in the context of the matters on which they are reporting’
(para 4, para 7, APB, 1995).

This need to consider materiality within a given context is reflected in professional judgement which constitutes a fundamental principle of external auditing. Audit involves the judgmental applications of the auditing principles, standards and guidance to the selection and evaluation of evidence in the particular circumstances of the client’s business (Porter et al., 1996). Thus, the auditor needs to be able to understand the client, and interpret the underlying characteristics of the client’s business within a wide environment. The appropriate collection and interpretation of evidence by the auditor can verify the assertions or events associated with the particular client. However, it could be argued that audit is a form of craft whose underlying concepts, such as materiality, resist precise codification, and where the auditor sees himself/herself as providing comfort (Pentland, 1993) rather than proof. The production of comfort is negotiated under the characteristics of the particular audit, in the context of the development of technical guidance. And since audit operates in situations which involve unknown elements and forces, feelings of reassurance in judgement processes must be represented as cognitive in form (Pentland, 1993). For the auditor, making things auditable is a practical issue; it is what one does when applying various techniques, routines and experiences. However, the auditor perceives himself/herself as a provider of reassurance. Thus, tensions exist between the practicality of audit, i.e. expected recognition of material misstatements, and auditor’s self understanding.

There are some differences in approach in professional practice to the understanding of the audit judgement concept between the US and the UK. The two areas where the judgement activities of the auditor differ between the UK and the US include ways of applying accounting and auditing standards and selecting an appropriate audit opinion². In applying accounting standards the US tradition is much more rule driven than the UK tradition, and therefore the range of judgement required by the auditor in the US seems much narrower than in the UK. The situation on the appropriate audit opinion’s selection does not differ much. In the US, SAS 58: *Reports on Audited Financial Statements* provides a template of opinion which states *presented fairly in accordance with ...standards* (AICPA, 1988); implying a narrower opinion than that given under British SAS 600: *Auditors’ Reports on Financial Statements with true and fair view* (APB, 1993). The notion *true and fair* means that the auditor has to take a judgement as to whether the information presented does present information fairly for the user to make decisions and that information has not been produced in a misleading fashion or been manipulated to show the client’s company in a

² Discussion with I. Marrian, ICAS, Deputy Chief Executive and Secretary.

better light than it in fact is (Percy, 1999). Thus, audit judgement seems more of an individual process in the British tradition.

There is no precise definition of professional judgement. In the UK a distinguishing feature of the underlying philosophy of auditing is a connection between professional judgement and the concepts of accountability and integrity.

‘[Audit] is about seeking the truth...[Judgement] is, in the final analysis, personal and derives from business understanding and experience as well as incisive knowledge of financial reporting and business life...an expert view with personal accountability’ (APB, 1994, p. 2 and 5).

Professional judgement, understood as incorporating concepts of accountability and integrity of a personal nature, goes beyond the concept of the *true and fair view* and beyond the agenda of compliance with auditing standards.

‘The purpose of the audit is to secure accountability’ (Flint, 1988).

‘Standards should not be slavish checklists followed blindly with the risk of damaging the robustness of the auditor’s opinion’ (APB, 1994).

Audit judgement is an independent process of giving understanding and meaning to generic principles by their application in specific contexts.

3.3 Aspects of judgement and decision-making studies in auditing literature

For many years auditing literature has recognised the importance and persuasiveness of independent judgement. Over the last decade an increased emphasis on improving the quality of audit has resulted in a number of studies concerned with the formulation of judgement and decision making. In many cases, academic research on independent judgement has been encompassed in specific paradigms or models of judgement. There has been a focus on judgement modelling in order to produce representations that reveal audit strategies. These models usually focus on inputs to, and outputs from, the decision process. However, to improve the quality of judgement it is necessary to get insight into the judgement processes of the auditor embedded in a wider environment, the meaning of judgement and abstract categories associated with it, such as independence, integrity, efficiency. Very little has been done in the area of the audit judgement process itself. Further, these heavily quantitative studies lack a concise, theoretical framework of the auditing milieu, where the individual auditor and his/her behaviour can be envisaged in a wider context. Below, an overview of judgement and decision making research is presented.

Most of judgement and decision making research in auditing has focused on (i) policy capturing, (ii) heuristics and biases, (iii) predecisional behaviour including information search and hypotheses generation, (iv) protocol analysis and (v) determinants of judgement performance (Trotman, 1997).

Studies on policy capturing attempt to identify the factors that influence judgement, and, on that basis, to build mathematical representations of judgement policies in order to reveal judgement strategies. This is generally done by providing subjects with a series of judgement situations with different combination of cues. Various statistical methods, such as ANOVA, regression and discriminant analysis are used to infer the judgement strategies based on the relationship between selected cues and the judgement made. All modelling approaches provide only surface statistical representation of relationships between inputs and outputs; they do not contribute to an understanding of cognitive and/or affective processes. The primary issues addressed by policy capturing research include consensus among auditors, the relative importance of individual cues for the auditor, the functional form of the judgement policy, the stability of judgement over time and the level of self-insight the auditor has into his/her own judgement policies (Solomon and Shields, 1995; Brown and Solomon, 1991, 1990; Ashton, 1982).

A number of studies dealt with judgement under uncertainty and different heuristics and biases associated with probability judgements. Into the heuristics and biases category fall studies which examine how the auditor's initial beliefs are combined with diagnostic evidence, often by comparison of judgement processes with predictions of statistical models. Several studies in probability judgement were attempted to clarify understanding of its concept as well as of the riskiness of the decision choices. Tversky and Kahneman (1974) and Bar-Hillel (1979) suggested that judgements under uncertainty are made in terms of causes and effects, claiming that causal information has a greater impact on judgement processes than equally informative diagnostic data. Shaklee and Fischhoff (1979) argued that when the auditor develops a sufficient causal explanation, additional evidence pointing to alternative causes may be underweighed while supporting evidence overweighed. Anderson and Sechler (1986) suggested a way of reducing the effect of causal explanations by an increase in the availability of opposing arguments.

Tversky and Kahneman (1974) formulated and tested a number of heuristics of human judgement suggesting that these heuristics reduce the complexity of cognitive tasks and respectively judgmental operations, and thus may lead to systematic individual errors. The anchoring and adjustment heuristic suggests that in many situations individuals make estimates by starting from an initial value and then adjusting that to get a final answer. The audit decision making process is sometimes viewed in the literature as the updating of beliefs on the basis of current information; prior year's working papers are likely to be adjusted in the process of devising the current year's audit programme. (Libby, 1981). The possibility, that this reliance on the previous year's

procedures results in insufficient adjustments, was of concern to the auditing profession for some time (Slovic and Lichtenstein, 1971; Tversky and Kahneman, 1973; 1974; Joyce and Biddle, 1981a; 1981b; Biggs and Wild, 1985; Butler, 1986). Heuristics and biases also exist in information search tasks. The auditor often formulates hypotheses to explain certain factors and then searches for evidence to test these pre-empted hypotheses. Some research employed Einhorn and Hoghart's (1992) belief-adjustment model: if an individual has strongly held initial beliefs regarding hypotheses, a disconfirming piece of evidence will result in a large decrease in revised beliefs. Subsequent confirmatory evidence seems to lead to another substantial upward belief revision and vice versa. The result is that the disconfirming-confirming order is hypothesised to lead to higher final beliefs than confirming-disconfirming order. Knechel and Messier (1990), Asare (1992) and Kennedy (1993) found a recency effect when auditors revise their beliefs on evidence; that is, auditors tend to place more weight on evidence received most recently. Further, Knechel and Messier (1990) found that negative evidence, in general, leads auditors to greater judgement revisions than positive evidence. This implies that auditors tend to examine evidence with a view of professional scepticism.

Alternatively to anchoring and adjustment heuristics, where the auditor chooses an initial estimate (based on either a best guess or the experience of the client) or anchors against new information and makes adjustments accordingly, auditing literature suggests that counterexplanation may result in more effective audit judgement (Koonce, 1992; Heiman, 1990; Kennedy, 1995). In counterexplaining, the decision maker is required to consider why the chosen alternative may be incorrect and/or why the rejected alternative may be correct (Koriat et al., 1980). Counterexplanation has been found an effective technique in social psychology for correcting over-confidence. In auditing, however, counterexplanation as a debiasing technique seems to be only desirable if it does not reduce the confidence of the auditor. Kennedy (1995) found inconclusive evidence that counterexplanation leads to professional scepticism. Synder and Campbell (1980) found that decision-makers generally prefer information that confirms their impressions rather than information that disconfirms them. Consequently, they often selectively review the data set for confirming information and ignore disconfirming information. This increases the availability of confirming information to decision-makers and results in an explanation effect. The explanation effect may be explained by what Hoch (1984) refers to as interference. When a decision-maker generates a set of reasons for or against the occurrence of an event, this act interferes with his/her ability to generate reasons against or for the occurrence of the event. Consequently, the alternative initially explained becomes more readily available to the decision-maker and influences his/her resulting judgements.

An extensive body of literature has addressed the areas of predecisional behaviour including studies on information search, hypotheses generation and protocol analysis (Anderson and Kida,

1994; Butt and Campbell, 1989; Kida, 1984). These studies were devoted to testing of the existence of the confirmatory bias: that is, situations in which individuals preferentially solicit confirmatory evidence for their hypothesis, as oppose to disconfirmatory evidence. A common finding for these studies is little support for the existence of the confirmatory bias. Anderson and Maletta (1994) found that experience plays an important role in the auditor's attendance to negative evidence: the less experience the auditor possesses, the more he/she focuses on negative information.

Most of the hypotheses generation studies have involved analytical review tasks. Libby (1985) examined the role of prior knowledge of financial statements' errors in the generation of hypotheses. Perceived error frequencies were found to play a major role in the accessibility of error hypotheses. Some studies showed the effect of individual experience on the generation of hypotheses (Bedard and Biggs, 1991; Kaplan et al., 1992).

Following earlier psychology and medical studies (Elstein et al., 1978) some research focused on the understanding of the processes by which audit judgement occurs³. Using verbal protocol analysis, the auditor's performance was examined with regard to the extent of audit testing (Biggs and Mock, 1983), review of a planned audit programme (Biggs et al., 1988) and hypotheses generation about unexpected fluctuations (Bedard and Biggs, 1991). It seems that verbal protocols provide somewhat greater insight into decision behaviour (Trotman, 1997). Verbal protocol analysis is one of the commonly used techniques in studies on judgement processes, whereby auditors are ask to think aloud as they perform a particular task; then their thoughts are analysed to examine all phases of the process from the beginning to the end (CICA, 1995).

Some studies documented shortcomings in the auditor's performance, such as the tendency for individual judgement to be subject to personal differences, resulting in various biases and errors. The auditor tends to perform well in tasks, which require processes involving generating ideas and constructing interpretations. Further, the quality of performance is likely to improve when the auditor's reasoning is theory driven, not simply statistically based (CICA, 1995).

Many studies have focused on revealing what audit judgement strategy can be apprehended as a first step to understanding the psychology of such judgements. Some studies have examined auditors' predictions of the client's corporate failure and its impact on their going concern decisions (Ashton, 1985; Simnett and Trotman, 1989); others examined auditor's subjective probability estimates of audit values in the pre-sampling phase of audit (Shields et al. 1987; 1988).

³ The importance of the hypotheses generation stage of diagnostic process has been well documented in psychological research (Roediger et al., 1992; Nisbett and Ross, 1990) and auditing research (Asare and Wright, 1995; Koonce, 1993), and some evidence in psychology suggests that hypotheses generation is the key to expertise in diagnosis.

In most studies on judgement strategies, agreement in fact refers to the similarity of overall judgements, namely consensus⁴, while agreement in principle concerns the similarity of judgement policies, i.e. cue usage⁵ (Ashton, 1982). The importance of consensus in auditing has been well documented in auditing literature reflecting a concern with the abstract category of objectivity in auditing:

‘In the best of all possible worlds, every auditor, given the same sets of facts, would select the same auditing procedures and apply them to the same extent’ (Hicks, 1974).

The existence of internal manuals combined with on-going training, and the review processes are expected to increase consensus among individual auditors within the particular firm. The purpose of research on cue usage has been to reveal judgement strategies. The research on cue usage involved studies on judgement stability (Ashton, 1974; Joyce, 1976), and on the accuracy of judgement confidence (Solomon et al., 1985; Mladenovic and Simnett, 1994). In order to improve audit judgement processes, it is necessary to get some insight into the more ambiguous layers of judgement processes, beyond the mere analysis of judgement strategies.

In considering the determinants of judgement performance the following equation was suggested by Trotman (1997):

$$\text{Performance} = f(\text{Ability, Knowledge, Environment, Motivation})$$

In this equation, audit judgement performance is a function of, and depends on, the auditor's individual ability, knowledge, and motivation factors embedded in a wider environment. Audit judgement research has emphasised the knowledge use by the auditor when exercising judgement. Some research has focused attention on the role of auditors' task specific knowledge in areas such as hypotheses generation (Libby, 1985) and information search (Kida, 1984). Some studies recognised that experience in audit plays an important role in a task assignment and that the experienced auditor relies on the wealth of job related knowledge brought to the tasks (Gibbins, 1984; Waller and Felix, 1987). Through on-the-job experience, the auditor gains knowledge and expertise that is organised in the brain in ways that allow him/her to work effectively.

⁴ Consensus is usually calculated as a grand mean across individuals, of the mean correlation coefficient with any one individual, or with all other individuals (Trotman, 1997). While the audit judgement literature used correlation analysis to calculate consensus, it is a construct validity threat. Trotman and Yetton (1985) attempted to overcome this problem by conducting a two way individual by case ANOVA, in which the cue effect measured the agreement in professional judgements across cases and the individual effect measured the auditor effect. For perfect professional judgements the within-case variance would be zero, and with the between-case variance accounting for all the sum of squares.

⁵ Cue usage has typically been measured by the significance of a cue in a statistical model (Trotman, 1997).

'Knowledge is an internal mental state which cannot be directly observed'
(Libby and Luft, 1993).

Libby (1995) noted that knowledge is a function of ability, experience, motivation and environment. He defined experience as task related encounters (e.g. comments from superiors, review of work of others, actual task completion, outcome feedback, staff training, etc.), which provide opportunities for learning in the audit environment. Knowledge was defined as information stored in memory comprising of episodic memory (i.e. particular experiences of the individual) and semantic memory (i.e. memory for concept meanings and relations). Abilities were perceived as the capacity to complete information processing tasks, such as encoding and analysis, contributing to problem solving. Performance was defined as the correspondence of a judgement to a criterion event.

Very important determinants of individual audit performance include wide environment and motivation factors. Research interest on environmental and motivational factors has emerged in the last decade. This research is more quantitative than any other area of research in audit judgement and decision making. Some research involved the examination of differences in audit firms' structure. (Cushing and Loebbecke, 1986; Kinney, 1986; Bamber et al., 1988). Cushing and Loebbecke (1986) documented variations in the structures of the largest audit firms across the USA: focusing on the guidance constituted in the audit manuals, and found that the degree of the structure in the particular audit firm impacts the auditor's perception of the work environment; in particular with regard to the ways the auditor approaches his/her judgmental tasks. They found that firms varied in how 'structured' were their audit methodologies. Highly structured firms were placing a strong emphasis on pre-engagement planning, explicitly defined responsibilities for each audit, shifted audit decision making from individual auditors towards the firm, tend to qualify audit risk during each audit with detailed guidance and placed high reliance on sampling techniques. Less structured firms emphasised pre-engagement planning and the use of internal controls questionnaires, but left the rest of audit process undescribed in detailed, quantitative ways. Similarly, Kinney studied structure in audit firms (1986). He concluded that unstructured firms use less structured guidance and leave more discretion to the auditor and that integrated tests, relying largely on statistical sampling methods and the consideration of the audit risk model, remain unspecified in such firms. Kinney (1986) classified audit firms as follows: (1) structured – Peat Marwick Mitchell (KPMG), Deloitte, Touche Ross (Deloitte and Touche Ross have since merged to form Deloitte & Touche), (2) intermediate – Arthur Andersen, Arthur Young, Ernst & Whinney (Arthur Young, Ernst & Whinney have since merged to form Ernst & Young), (3) unstructured – Coopers & Lybrand, Price Waterhouse (now merged to PriceWaterhouseCoopers). Cushing and Loebbecke's (1986) study and Kinney's (1986) classification suggests that audit firm structures are associated with methods used to co-ordinate and control auditors: that is, the

auditor's role with more structured firms is to organise audit tasks so as to be more analysable, devoting more energy to standard operating procedures, and the manner for making assessments of audit risks for clients. McDaniel (1990) examined the effects of audit structure and time pressure on audit sampling tasks and motivation of the auditors. Again this is an example of examining together the effects of various determinants of judgement performance.

Libby and Luft (1993) suggested that other environmental factors, including prior audit engagements and accountability issues, as well as motivational factors, seem to be important as characteristics of the auditing milieu. Gibbins (1984) and Gibbins and Emby (1985) emphasised the need to incorporate accountability relationships in the audit judgement framework. They suggested that justification plays an important role in evidence gathering, and that understanding of audit judgement requires these factors to be considered. Experimental studies that have addressed issues of accountability include Ashton (1990), Kennedy (1993) and Peecher (1996). Auditing research suggests the influence of embeddedness in the client, i.e. repeated audit engagements, as another important characteristic of audit setting. On most audits there is usually carryover of audit personnel from prior years (Tan, 1995).

Recently, there has been an increased interest in emerging research on other environmental and motivational factors in the audit judgement setting. Libby and Luft (1993) argued that incentive-induced effort may well interact with the abilities and knowledge of an individual. Grey (1998) used documentary materials and interviews to analyse ways in which auditors perceive their professionalism. Staff Evaluation Forms are used to assess auditors and consultants. These forms comprise of six main sections: technical ability, client service, quality of work, job administration, time management, managerial skills, professional and personal attributes. The auditor is evaluated in each category on 5-point scale from 'outstanding' to 'unsatisfactory'. The category of 'professional and personal attributes' defines the everyday ways in which being a professional is constructed within the firm, at least by those who design and implement the evaluation system. The attributes for evaluation include the following

'[C]ommunication, self-confidence, initiative, ability to win confidence and respect from clients and colleagues, performance under pressure, co-operativeness, reliability, professionalism, self-motivation, business sense, integrity, judgement, enthusiasm and commitment, appearance, team working, ability to follow instructions and accept responsibility, decision making, presentation skills, contribution in meeting' (Grey, 1998, p. 575).

Under other sections Grey found attributes related to professional and personal characteristics including

‘[R]esponding to client, managing client’s expectations, logical organisation of written work, neatness of written work, creativity, time management, meeting deadlines, prioritising work’ (Grey, 1998, p. 575).

Grey (1998) concluded that the notion of professionalism in all attributes is bound up with ways of conducting oneself. Being a professional is not a ‘personal view’ but how one behaves ‘within earshot of other people’, and is perceived as being linked with behavioural functionality to working with clients (p. 579). Consequently, auditors find themselves as being evaluated in terms of their behaviour, rather than their technical competence. This is accommodated partially by the fact that the auditor of the Big Five ‘type’ supplants a wider understanding of professionalism with conformity to the professional body of knowledge encompassed in the organisational norms. Similarly, Radcliffe (1998) discussing efficiency audits argued that, although audit manuals, standards, etc., promote abstract ideas of independence, efficiency and effectiveness, in practice auditors tend to use these terms more to refer to their work in general rather than to describe matters with the fineness of meaning found in financial statements.

Until recently very little research has focused specifically on the socio-economic environment of independent judgement within the realm of the auditing profession. The review of the main streams of research in audit judgement and decision making conducted the over last decade has focused heavily on quantitative methodologies. More ambiguous aspects of judgement processes, however, cannot be measured by solely statistical models. Although the shortcomings of the auditor’s performance were of a concern in the prior research, these studies were limited to the explanations a few factors associated with personality traits, and not embedded in the wider context of the auditing milieu. Prior research carries out a substantial bias towards evidence findings and lacks a conceptual framework of the auditing milieu in which judgements are formed and deformed. Since the auditor performs well in processes of generating ideas and constructing interpretations (CICA, 1995), research has to develop an altogether more localised focus with qualitative indicators complementing statistical criteria, attending to the auditor’s detailed understandings and his/her operational practices in unveiling the degrees of insight the auditor has in his/her judgement processes (Jonsson, 1998).

3.4 The system of knowledge in the auditing profession

Trotman (1997) indicated that the auditor’s performance is defined by a degree of correspondence of audit judgement to a body of professional knowledge. Growing expertise in society is organised around occupations and professions. Audit practice, like any practice bounded by economic constraints, is characterised by normative and operational components. The former constitutes the ideas and concepts of dominant ideology which shapes the mission of the practice and positions the practice in relation to the wider objectives of political spheres. Operational elements consist of

tasks and routines, which make up the world of audit practice. Methods, checklists, samples etc constitute a codified and formalised body of knowledge in audit practice, thereby allowing the audit process to be written up and recorded (Power, 1997, pp 6-7). Claims about the possession of knowledge and the display of appropriate behaviour are important elements in the constitution of professionalism (Grey, 1998). The importance of expert knowledge in the formation and the survival of professional services' firms, such as auditing and consulting firms, has long been recognised (Morris and Empson, 1998). The body of knowledge developed simultaneously by individuals and organisations is stored and preserved by professional coding schemes. While individuals generate knowledge through their thought processes, organisations are envisaged as the repositories of knowledge through a dissemination of routines and procedures (Nelson and Winter, 1982).

There are different views on organisational knowledge in the literature. Linked with the resource-based view of the firm, a knowledge (base) is envisaged as a key determinant of the organisational structure and performance of audit firms. (Conner, 1991, Morris and Empson, 1998). Knowledge is seen as means of gaining and sustaining competitive advantage in post-industrial economies (Drucker, 1992). The knowledge base represents both an input and an output in terms of the expertise residing in the firms and it is an output in the form of products or services generated to serve client's problems (Grant, 1996). Despite different views on the role and meaning of organisational knowledge, it is argued that the basis for the existence of professions stems from its possession.

'The power of professions stems from their ability to exclude others from the technical and legal basis of their practices, thus enabling skills to be translated into material and symbolic rewards' (Larson, 1977).

But Power (1991, 1997) argues against the essentially functionalist approach in the sociology of professions.

'The existence of technical knowledge is never a sufficient condition for its institutional implementation' (Power, 1991, p. 335).

In addition to technical knowledge, there are complex and inter-personal dynamics inherent in its development and dissemination within firms (Morris and Empson, 1998). In other words, knowledge in organisational settings is not simply based on objectified reality, but is socially constructed. Although the technical skills of the auditor are emphasised in his/her formal qualifications, actual day-to-day work in the field may be more concerned with the deployment of inter-personal skills and the maintenance of the professional image.

The system of knowledge in auditing consists of four principle levels: (1) official knowledge, (2) training and education, (3) practice in the field, and (4) quality control (Power, 1997, pp. 36-39). The first level is concerned with institutionalised knowledge structures of audit practice including its codified rules, regulations on appropriate procedure or behaviour evolving over time. Such routines are often developed ad hoc at the level of practice and, due to societal demands, become codified at the level of a firm's internal documentation, and more abstractly at the level of professional and regulatory bodies. All these procedures constitute what is often referred to as *generally accepted practice*. The audit working papers, not sufficiently analytical and partly descriptive, do not tell the story of why particular audit decisions are made. The process of writing up makes the audit process conform to its institutionalised knowledge base. The second level of the system constitutes mechanisms of procedural knowledge dissemination, including training, education and socialisation processes. At this level tacit rules of know-how are learned –that is styles of behaviours and discourses, the need to 'look busy' etc - as well as practical skills. Formal examination systems act as barriers to entry supporting the institutionalisation of audit knowledge by connecting procedures to legitimate forms of its abstract knowledge (Abbott, 1988). The third level is associated with practice itself where audit judgements are made and written. The auditors negotiate facts in the audit process in the contexts of discretion while interacting with the clients who often resent the intrusion. These facts also emerge from 'lonely monotony of backroom adding and subtracting' and 'ticking and bashing' (Stevens, 1981). The final element of the system concerns the feedback mechanisms by which the remaining three levels - official knowledge, practice, training and education - get connected to broader issues of quality. This is not a discrete level of the system, but is built into all others, often as a response to the external pressures for a reform. This system represents a powerful model of how a legitimate field of auditing practice is organised: that is, auditing practice is operationalised in the form of a series of routines, which are economically constrained to more abstract metaphors of *best practice* on the one hand, and have a certain institutional credibility as a technique on the other.

Audit practice is expressed in its technical side where methodologies are designed to depict the client faithfully and efficiently (a technique is focusing on the creation of facts which depict the client), and in its social side complicit in modifying and regenerating the profession's abstract body of knowledge, which reflects in turn its own-interest (a mean for monitoring the auditor's decisions by making his/her judgements more visible, knowledgeable and documentable) (Carpenter and Dirsmith, 1993). In other words, auditing practice includes both numerical computations of the client's financial position, and particular discursive representations and vocabularies.

Knowledge categories within the audit firms include: (1) individual and codified expertise based knowledge, (2) individual and tacit experience based knowledge (knowledge of a client's group or

an area, including an unrivalled range of personal contacts, and know-how of the individual auditor), (3) collective tacit knowledge embedded in the routines of people as they carry out every day assignments or encultured in the ‘way that people do things around here’, and (4) collective codified knowledge (institutionalised knowledge base of auditing exemplifies codified knowledge)⁶. Nonaka (1991) classified knowledge into tacit and explicit. The latter is formal, systematic, more easily communicated and disseminated in forms of codes and formulas. Tacit knowledge incorporates highly subjective insights, intuition and ideas of the individual. Tacit knowledge is deeply rooted in action and in the individual’s commitment to specific context – a craft or profession. Tacit knowledge consists partly of technical skills, kind of informal ‘know-how’. Evaluation, assessment, checking accounts are part of everyday practice mostly explicit, but sometime take place as a part of the tacit understandings which constitute practice embedded in the wider social context. At the same time, tacit knowledge has an important cognitive dimension. It consists of mental beliefs, strategies, and perspectives so ingrained in the individual that he/she takes them for granted, not being able to articulate them easily.

‘We know more that we can tell’ (Polanyi, 1962 cited in Lam, 1997).

These implicit means profoundly shape how the individual perceives the world. Knowledge of experience refers to tacit knowledge which is contextually bound and accumulated by action. In contrast, knowledge acquired through formal training – a way of learning congruent to external auditors - is generic in nature, more abstract, theoretical, standardised, internally coherent, and tends to develop with regard to the *best practice* of the profession.

Morris and Empson (1998), incorporating Blackler’s (1995) and Nonaka’s (1991) classifications presented types of knowledge within the professional firm (Table 3.2).

Table 3.2
Knowledge heterogeneity within the professional firm

<i>Forms of knowledge Focus</i>	Codified	Tacit
Individual	EXPERTISE/TRAINING (EMBRAINED)	EMBODIED IN EXPERIENCE WISDOM AND TECHNIQUE
Collective	PRECEDENT/SYSTEM/ PROCESS (ENCODED)	EMBEDDED IN ROUTINES AND RELATIONSHIPS (ENCULTURED)

(source: Morris and Empson, 1998, p. 615)

⁶ Blackler (1995) suggested five dimensions of knowledge: embrained, embodied, encultured, embedded, and encoded. Embedded knowledge resides in systematic routines and procedures. Both embedded and encoded categories represent the collective codified knowledge base.

Table 3.2 implies that firms develop different types of knowledge. However, not all aspects of knowledge in the audit firm may be subject to standardisation processes. Some firms may find they can collectivise knowledge but not codify it in detail. Or, some firms may not try to appropriate tacit knowledge but aim to secure a share of the rents accruing from it. Although the knowledge base in the audit firm is heavily codified, it is also constantly evolving. The knowledge requires to be constantly renewing and updating (experience-based interpersonal skills seem highly valuable). The shaded area of Table 3.2 represents (1) tacit individual knowledge, and (2) encoded knowledge of the audit firm. These categories of knowledge seem to mediate dynamics between judgement and structure categories; they are in particular of relevance in the present study. Within the structure of collective knowledge, the study seeks insights into the usage of individual tacit experience. Not all the knowledge may be a subject of codification strategies. An appropriation of some aspects of tacit knowledge may not be susceptible to a transfer or storage without deterioration.

The knowledge base of the audit firms is embodied in its professional staff. Auditors believe that their knowledge of the field usually refers to knowledge of the client which is fundamental to their work. In other words, the client's knowledge is an important source of power and prestige of the professional firms. Auditors' knowledge of clients comes to delimit what is for them the organisational reality within which they work. The financial and operational circumstances of the client provide an important base, including the language, norms, and ideas circulating in both clients' departments and in the wider audit environment. The auditor reacts to and acts upon the environment; this dialectical relationship illustrates the mutual constitution of organisations and environments (Neimark and Tinker, 1986). The knowledge base of the client is accumulated mainly through informal, tacit means; through personal experience, through mistakes, and continuing involvement (Radcliffe, 1999). Knowledge of the client's business is significant in the establishment and pursuit of auditing tasks, but is largely unrecorded in conventional terms, and, in effect, is written into the collective memory of auditors appearing in discursive formations.

Although, on the whole, the knowledge base in auditing is codified and thus structured, knowledge with regard to fraud is rather excluded from this structure. Fraud knowledge and experience is content and contextual dependent: embedded in the industry specifications and the client's further particulars: such experience is not easily codified to facilitate structured inquiry. Thus, fraud knowledge transfers a require highly diffused and fluid approach to the audit process and the underlying systems of unstructure enabling its individual dissemination⁷.

⁷ For example, the Japanese organisational model seems facilitative of processes of fraud knowledge transfer and dissemination. Knowledge may be accessed via intimate, socially constructed networks of individuals (Nor, 1999).

Radcliffe (1999) argued that procedures, guides and documentary analysis, associated with the popular image of auditing as a bureaucratically rational practice, seem to be of a relatively minor value in the field. He realised that some auditors themselves turned away from such tools, having found them to be of limited value. Those auditors perceive the local discourse and tacit knowledge that they accumulate over time as being an essential resource that allows them to make audit traceable. Thus, applied knowledge may derive from theoretical principle and standardisation, but is also developed experimentally as interpretations in the form of responses to current clients' problems. Newly created knowledge is likely to be informal and tacit (Nonaka, 1994, Morrison and Empson, 1998). If the knowledge base is not updated and renewed, the firm runs the risk of offering yesterday's solutions to the current problems of its clients.

By constituting the knowledge base in procedural terms, the nature of auditing is elusive and somewhat obscured. Thus, the issue sits deep in the heart of practice and including a wide environment concerns the relative balance between trust in independent judgement and the need for conformity to formal and publicly defensible rules of the conduct. A social construction of the auditing milieu requires embeddedness of its judgement in a contextual framework.

3.5 A framework for professional judgement

The very nature of the financial statement audit is socially constructed (Power, 1997; Grey, 1998), and therefore simultaneously affects and is influenced by the society in a wide environmental context. Broadly defined environment, a body of professional knowledge, legitimacy processes, accountability issues, the auditor's characteristics, specific features of the audit task and the decision making process itself, all build up interrelated key components of a framework for professional judgement. A simple depiction of the milieu for the professional judgement of the auditor is presented in Exhibit 3.2.

Without knowing the characteristics of the environment in which judgements are made, it seems impossible to evaluate its quality. Broadly defined, the environment affecting professional judgement encompasses: (1) the audit clients, including knowledge of their needs and their businesses, (2) competitors and competitive pressures deriving from the audit services market, (3) the auditing profession including its international professional bodies, in particular their role in the administration of professional standards and guidance enveloped in the legitimacy claims, (4) government with its statutory law, (5) financial statement users and their needs, (6) society with their opinions and values, and (7) the audit firm itself including its culture, internal policies and procedures, hierarchy, organisational pressures, etc.

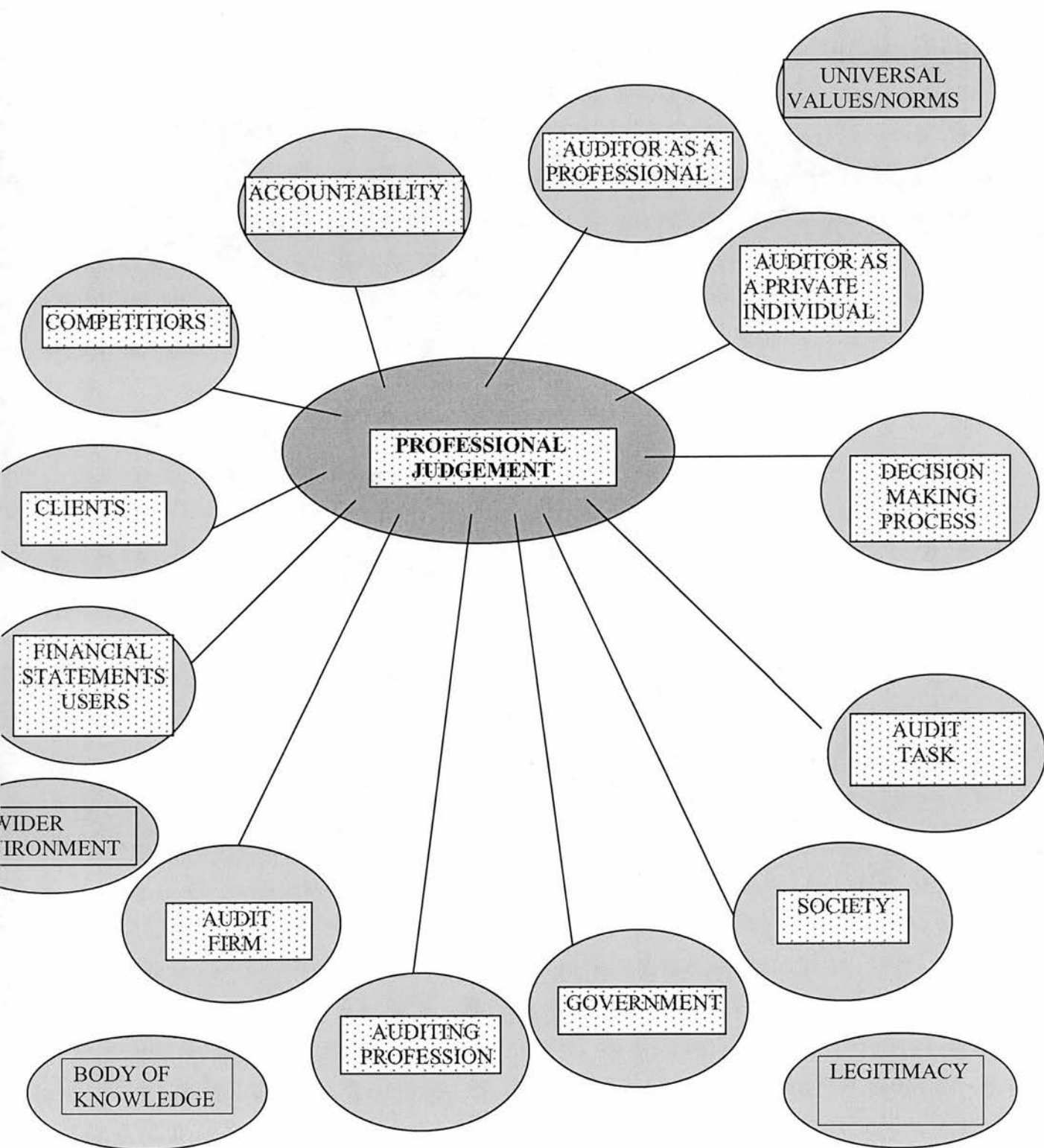


Exhibit 3.2
The audit judgement milieu:
A simple depiction of reciprocally interrelated components of professional judgement

The auditor develops a level of knowledge concerning the clients, sufficient to obtain an understanding of the events and transactions that are interpreted and executed in judgement. These may have a significant effect on the audit process. The auditor's level of knowledge appropriate for an engagement with the particular client should include a general knowledge of the economy and the industry within which the client operates and the knowledge of the client itself.

Acceptance of, and continuity with, clients means interpreting them and anticipating potential problems. The audit judgement is significantly influenced by the level of cognition (i.e. individual codified knowledge) and affection (i.e. 'gut feeling') in the first stages of the audit process⁸.

In the last two decades increased competition in the provision of audit services, socio-economic development and the globalisation of markets have resulted in time and fee pressures in the audit firms (see chapter 2 for more details). Demands imposed on auditors have been extended: an increased workload leads the auditor to struggle in order to balance the nature and extent of audit work with the desire to maintain good relations with the client. Public pressure on the auditor to exert high quality in professional judgement and, simultaneously, competitive pressures on the audit services market, make it difficult to perform audit responsibilities within given time and fee constraints.

The auditor must be continually aware of these pressures since they may introduce undesirable biases in judgements. The role of the audit firm, in particular its culture, internal policies, procedures, and codes of conduct, are all significant to audit judgement. There may be situations in which the auditor encounters compliance dilemmas between the internal policies and procedures of the audit firm, and his/her level of subjectivity and scepticism applied in judgement. The role of the auditing profession and its authority in the development of auditing standards and guidelines, and codes of professional conduct (The Auditor's Code, APB, 1996), as well as the government with statutory law (Companies Act 1985 and 1991), are important jurisdictionary elements of the audit environment in which judgements are made. Professional standards have a pervasive influence on professional judgement since auditors, embedded in the dynamics of legitimisation processes are regarded as bearers of professional knowledge, and are ethically bound to conform with those standards. However, some demands for professional judgement arise because of imprecision and inconsistency in the wording of the standards and/or because of a lack of specific guidance in more ambiguous audit contexts.

⁸ The pre-engagement decision process is seen as the most important step in the audit process because no other controls can adequately mitigate the adverse effects of a decision to serve an undesirable client (Murray, 1992).

Accountability is an important factor in a framework for professional judgement since audit is about judgement (APB, 1994) and the purpose of the audit is to secure accountability (Flint, 1988). Accountability may be envisaged as a duty to provide an account of the actions for which one is responsible. It encompasses a pre-existing expectation that justification may be called for. Accountability can be seen as a relationship involving giving and demanding the reasons for conduct (Giddens, 1984). To be accountable is to be liable to present account of, and answer for, the execution of responsibilities to those entrusting those responsibilities (Roberts and Scapens, 1985). The general framework of accountability in the accounting and auditing literature is the principal-agent model (Power, 1991, Laughlin, 1996) which assumes that a principal (an individual or an organisation) has certain rights to make demands on the conduct and the reasons for conduct of an agent. These rights are assumed to derive from the fact that the principal transfers resources to the agent with expectations as how these resources are to be used.

'He who pays the piper calls the tune' (Laughlin, 1996).

Thus, financial accountability imposes on an agent (the audit client) the obligation to supply periodic ex post financial accounts to a principal (the shareholders) on uses of resources which have been entrusted to the former by the latter. Because the client, third party or other audit firm can call a particular act or an event into question at any time, auditing decisions must be defensible. The auditor must be prepared to justify, document and take responsibility for judgements and decisions with regard to (un)qualifying the financial statements, as a means of providing assurance to society. In view of the consequences of such work, the auditor is always faced with the prospect of being held accountable for any audit judgements or actions. The profession requires the auditor to act in the interest of primary shareholders, whilst having regard to the wider public interest.

'The identity of primary stakeholders is determined by reference to the statute or agreement requiring an audit: in the case of companies, the primary stakeholder is the general body of shareholders' (The Auditors' Code, APB, 1996).

The individual possesses potentially diverse forms of knowledge, different tastes and preferences (e.g. tolerance for ambiguity), a specific memory structure embedded in hermeneutic circles – or more specifically a unique combination of individual-specific characteristics. Hence, individual characteristics can influence the execution of professional judgement. The auditor exists simultaneously as a professional and as a private individual. The distinction has to be made between those personal characteristics of the auditor required by the profession and those 'residing' in the personality of each individual. The auditor envisaged as a professional is independent, knowledgeable and experienced, maintains professional competence and is aware of

the judgmental biases. The auditor envisaged as a private individual is affective, has inquisitiveness and innate scepticism reflecting societal and ethical values. Quinn et al. (1996) argued that a professional intellect operates on four levels: cognitive knowledge, skill, system understanding, and self-motivated creativity. Cognitive knowledge is a base for mastery of a discipline achieved through training and education. Advance skills translate 'book-learning' into effective execution; the ability to apply the rules to complex client's problems. System understanding is knowledge of the cause and effect relationships underlying the profession. It permits moving beyond the execution of tasks to solve more complex problems with the innate ability to anticipate subtle interactions and unintended consequences. The ultimate expression of systems understanding is the level of applied intuition – through the tacit means of the individual. Self-motivated creativity consists of will, motivation, and adaptability in the midst of the firm culture. These interrelated characteristics make the auditor an independent professional, capable of making things auditable.

The assertion of professional conduct involves assessing the auditor's performance according to notions of independence, objectivity and integrity. These audit concepts are interrelated. The independence of the auditor relates to the circumstances that would favour the application of unbiased judgement in arriving at the opinion or decision in a particular situation, whereas objectivity relates to the auditor's state of mind that results in the application of unbiased judgement (APB, 1996). Objectivity is characterised by integrity and an impartial approach to professional work. The auditor's professional integrity provides a benchmark for assessing the objectivity of the audit opinion (Bartlett, 1993). The rules of professional conduct require independence and objectivity of the auditor (APB, 1996). Thus, the auditor as a professional has a fundamental responsibility to exercise the highest standard of professional judgement based on these abstract concepts of independence, objectivity and integrity. Audit firms should be concerned with a development of quality controls specifically aimed towards securing these concepts.

The auditor's expertise is envisaged as another determinant which influences audit judgement, a concept difficult to define and operationalise. One of the important determinants of expertise is a general problem-solving ability, which includes the ability to recognise relationships between data, interpret data and reason analytically. To provide high quality in audit services the auditor must continuously review his/her knowledge. On-the-job experience and training helps the auditor to acquire the requisite expertise and skills. The experienced auditor can readily distinguish relevant evidence from irrelevant data in the specific problem, and apply relevant knowledge to accept the responsibilities for the outcomes of the decision. The auditor has to be able to adjust decision-making strategies to fit particular situations. In addition, experience assists the auditor in insightful recognition and evaluation of more ambiguous and/or conflict situations, and enhances overall decision-making ability. A significant part of the auditor's experience relates to the accumulated

knowledge of a priori performed audit tasks and embeddedness with particular clients (Bedard et. al., 1994). To sustain professional competence, the auditor needs to participate in on-going training and continuous self-education by keeping informed and complying with developments in professional standards and guidelines, revising his/her knowledge base (codified and tacit), and being responsive to eventual changes.

‘Auditors act with professional skill, derived from their qualification, training and practical experience. This demands an understanding of financial reporting and business issues, together with expertise in accumulating and assessing the evidence necessary to form an opinion’
(The Auditors’ Code, APB, 1996).

Further, the ability to know one’s own limitations relates to the auditor’s level of self-knowledge. The auditor, aware of his/her own limitations must be prepared to consult with others.

The auditor’s personal characteristics ultimately affect his/her actions and thus have an impact on audit judgement processes. Each individual person has a particular way of perceiving the world and existing in the world. The phenomenology of the individual is shaped by a particular culture, embeddedness in a widely defined environment, and learning processes; then is adjusted according to personal beliefs, societal norms and universal values. The nature of our beliefs is related to human emotions, needs and attitudes. Here, an affective side of judgement disseminates. Thus, the personality of the auditor and his/her expertise and experience are intertwined and interrelated in the judgement process. It is argued that certain auditors are more likely to defer to management representations in order to avoid potential conflicts between a particular client and the audit firm. Personal characteristics of the auditor which have an impact on his/her capacity to doubt what is seen as the truth under pressure include: (1) scepticism and affect, (2) ethical orientation, (3) conflict management style, and (4) ego strength. These individual differences of the auditor as a private individual seem to be relevant in particular at the planning stage of audit. There are many classifications of personal traits affecting individual behaviour in decision making. This selection is based on a literature review on audit judgement and decision making studies (see section 3.2).

A notion of scepticism relates to the level of applied intuition in the audit process. It is a personal ability to be distant and to doubt what is seen as a truth, in particular with regard to complex, and/or conflict situations. An attitude of professional scepticism is inherent in the exercise of professional judgement. The auditor’s scepticism derives from requirements of professionalism, but originates in the personality of an individual.

‘Auditors approach their work with thoroughness and with an attitude of professional scepticism’ (The Auditor’s Code, APB, 1996).

Without the attitude of professional scepticism the auditor may not recognise red flags in the client's environment. Red flags are factors that increase the risk of material misstatement and circumstances which indicate that the financial statements could be materially misstated. Thus, the auditor may draw inappropriate conclusions from gathered evidence. On the other hand, the auditor who approaches each audit with obsessive suspicion and paranoia, viewing each transaction or circumstance as a likely fraud, would never be able to complete any audit. Thus, the level of professional scepticism applied in audit should be somewhat intuitively balanced in order to sustain the high quality of judgement.

Conflict management style also seems to affect individual judgement in the audit process since conflicts at the work place may produce either positive or negative consequences for the audit firm. The result of the conflict often depends on the method of conflict management adopted by the individual involved (Schwenk, 1990). Individuals may perceive conflict situations harmful either for themselves or for the organisation, and in that case are likely to view each situation with suspicion. As a result of these perceptions, they tend to avoid conflicts (Janis and Mann, 1977). On the other hand, certain individuals may tend to view unpleasant conflict situations as productive and constructive (Tjosvold, 1985). In either case, the outcome of conflict situations seems to be significantly influenced by decision makers conflict management style. In the auditing profession the auditor frequently finds himself/herself in complex situations where conflict may arise. There are instances when the most pervasive type of evidence can be obtained only via thorough inquiry of the client since the client's management seem to be the only reasonable sources for answers concerning underlying features of internal controls, unexpected fluctuations or certain accounting estimates (Koonce, 1992). For instance, the client may provide the auditor with explanations concerning particular features of the internal control system and the auditor must decide if these representations are reliable and competent as evidential matter. In a situation when the auditor considers information provided by management as incomplete or unreliable, he/she will demand additional testing with the risk of open conflict with the client over a potential fees re-negotiation. However, if management representations are considered as sufficient and reliable, potential conflict is suppressed and no further testing is required. In addition, negative attitudes towards the client may affect the categories of efficiency and effectiveness of the independent audit by limiting the auditor's willingness to interact with the client's management. Since the evidence gathering phase of the audit involves ongoing communication with the client, the perceived severity of communication barriers seem to have an impact on how much interaction between the client management and the auditor actually occurs. If the auditor perceives significant barriers to communication and fears to create a potential conflict in the relationship, he/she may perceive interaction with the client's management as non-useful or insufficient. As a result, the auditor may avoid the client and attempt to gather information for evidence using alternative sources. The auditor should be aware of his/her own attitude to conflict situations with the client while making a

judgement, in order to be able to foresee the risk of bias over the decision made which his/her personality may implicitly impose.

Ethical orientation is one of the important individual characteristics of the auditor affecting judgement. Auditors must be sensitive to ethical situations (Mautz and Sharaf, 1961). Several studies have indicated that individuals with high moral standards are more sensitive to ethical audit issues associated with client integrity and competence (Ponemon and Gabhart, 1990; Trevino and Youngblood, 1990; Shaub et al., 1993; Bernardi, 1994). Ponemon and Gabhart (1990) claimed that the moral development of the auditor could affect the audit strategy and its effectiveness. Ponemon (1990) demonstrated a relationship between individual ethical reasoning and the audit judgement with regard to client integrity, and thereby noticed an important link between the auditor's moral development and the quality of audit. Shaub et al. (1993) found that the auditor's ethical orientation is associated with increased sensitivity to ethical issues. Bernardi (1994) found that audit managers sensitive to moral issues tend to detect fraud at a higher rate. Therefore, it can be argued that auditors with high personal morality tend to be more sensitive to management (mis)representations and to red flags indicating the potential risk of material misstatements, and accordingly to be more alert to recognition of potential fraud.

Kohlberg (1976) argued that most individuals develop heuristics for dealing with complex, controversial issues and dilemmas, and these heuristics fall into different stages of moral development: (1) pre-conventional, (2) conventional, and (3) post-conventional (Table 3.3). In the pre-conventional stage, individuals make moral decisions based on the consequences of an action, such as reward, exchange of favours, punishment or on the unquestioning deference to power (mode 1), or the right action is defined as that which satisfies individual needs, and the elements of fairness are interpreted in terms of physical or pragmatic consequences upon the decision maker. In mode 2 egoistic reasoning applies to the interest of an individual, resulting in a trade-off between self-interest and public interest. In the conventional stage, rules within the society and the needs of others are relevant to the moral reasoning of the individual. Mode 3 emphasises behaviour in order to gain approval from others for the decision maker; thus the significance of conformity to stereotypes of majority, or acceptable behaviour is underlined. Within mode 4 an individual takes the perspective of a generalised member of society. Thus, in this mode, emphasis is put upon adherence to set of societal, legal or religious procedures. This mode reflects upon deontological or contractual reasoning, where a person uses logic to identify duties or imply contractual obligations. Deontological or contractual reasoning is reflected in professional codes of conduct. In the post-conventional stage, the good of society is included in the moral reasoning of the individual. Mode 5 emphasises the possibility of changes in law based upon rational considerations of social unity. Mode 6 defines 'right' by the consequence of the decision maker in accordance with self-chosen

ethical principles appealing to logical comprehensives, universality and consistency⁹. If the auditor’s response to an ethical dilemma is related simply to following professional ethical standards and guidance, i.e. compliance audit, it would have an equivalence to using societal rules to frame individual response in Kohlberg’s stages of moral development (mode 4).

Table 3.3
Kohlberg’s stages of moral development

Stage	Mode
1.Pre-conventional	1: Punishment and obedience orientation 2: Instrumental relativist orientation
2. Conventional	3: ‘Good person’ orientation 4: Law and order orientation
3. Post-conventional	5: Social contract legalistic orientation 6: Universal ethical principle orientation

Increased sensitivity to broader and more idealistic, ‘what should be’ notions of behaviour are associated with the two highest modes in Kohlberg’s approach: a post-conventional stage (mode 5 and mode 6). The auditor at these higher modes tends to be more sensitive to ‘what should be’ issues, such as judgements that may relate to public expectations, higher quality, higher rate of fraud recognition, etc. Table 3.4 below presents an application of Kohlbergian moral development to individual audit judgement.

The stages of moral development attempt to identify the auditor’s perceptions on his/her use of fairness in the judgement processes. Because of the fact that the auditing profession has a long tradition of formal codes of ethics, there is a danger that auditors may tend to view ethics¹⁰, and respectively ethical dilemmas, according to dichotomous criteria; ‘covered/not covered by the professional code’ (mode 4). Thus, the auditor needs to transcend the conventional stages, applying judgement with the notion of scepticism, mediated by individual values and professional experience.

⁹ Literature provides several techniques for measuring moral judgement: the Moral Judgement Interview (Kohlberg and Colby, 1987), the Defining Issues Test (Rest, 1986; 1979) and the Multidimensional Ethical Scale (Reidenbach and Robin, 1995; 1990; 1988; Hansen, 1992). This study does not tend to quantify the level of moral judgement of an individual since each technique carries a bias resulted from measuring stereotyping and prejudice opinions on ethical behaviour, rather than authentic, rational judgement. Hence, the morale of the individual is encompassed in the theoretical framework for audit judgement.

¹⁰ Definition of ethics from gr. *Ethos* - a set of moral principles of good, right, duty, obligation, virtue, freedom, rationality and choice involved in practical reasoning concerning human conduct (Oxford Dictionary of Philosophy).

Table 3.4

The auditor's stages of moral development: A Kohlbergian approach

Stage	Mode
1. Pre-conventional	1. Obedience to the hierarchy and authority in audit firm, and promotional incentive orientation. 2. Successful cost-effective audits, efficiency drive and promotional incentive orientation
2. Conventional	3. Stereotypical, encultured in the audit firm Acceptable behaviour, internal policies/manuals compliance orientation. 4. Professional standards and guidance, law compliance orientation; <i>good practice</i> .
3. Post-conventional	5. Quality and evolving standards orientation. More judgement, interpretive practice. 6. Awareness of evolving nature of professional standards and law in accordance with universal ethical principles orientation. Highest quality of audit services. Interpretive, judgmental practice

The ability of the individual to self-direct activities in complex situations, i.e. field independence, is an important characteristic affecting audit judgement, since the auditor evaluates information and identifies problems embedded within the context of a wider environment prior to making a decision. Ego strength moderates individual capacity to doubt what is regarded as truth. Ego strength is associated with strength of conviction and self-regulating skills. Individuals with high level of ego strength benefit from a high level of self-esteem. High self-esteem is manifested in one's self-respect, appreciation of own merits and recognition of own faults to overcome. Hence, individuals with higher self-esteem tend to evaluate data in ambiguous situations better. Individuals with a high level of motivation to self-direct their own activities are better at problem solving (Cohran and Davis, 1987) and decision making (Benbasat and Dexter, 1982). Pincus (1990) found that more field independent auditors detect fraud at higher rates.

The features of the audit task build up another factor within a framework for audit judgement. The specific features of the audit task, in particular the type of audit evidence sought in relation to materiality and audit risk¹¹, impacts the exercise of professional judgement.

¹¹ The audit risk model is a core of the risk-based audit methodologies. The audit risk model consists of three components: the inherent risk, the risk that material misstatements will occur; the control risk, the risk that internal controls do not prevent or correct material misstatements; and the detection risk, the risk that the audit procedures will not detect material misstatements (SAS 300, APB, 1995).

The auditor tends to be particularly sensitive to audit evidence with respect to the hypotheses assessing fair presentation of financial statements. The evidence available to the auditor is often persuasive in its nature, not conclusive, in which case judgement permeates the auditor's work. Further, evidence is influenced by more abstract categories, such as materiality, inherent risk, efficiency, etc. The auditor is required to obtain sufficient and appropriate evidence. Audit judgement with respect to appropriateness and sufficiency of audit evidence is influenced by materiality and audit risk considerations. Decisions over materiality and risk form the basis for determining the extent of the auditing procedures to be undertaken.

In the mid-1960s various forms of statistical sampling in audit were replaced by the system approach of analytical auditing based largely on the examination and evaluation of internal control systems. In the mid-1980s analytical auditing was supplemented by the risk approach based on the audit risk model. This model focuses the audit accordingly to materiality and risk judgements, reducing the audit of areas low in inherent risk and low in control risk. In the beginning of 1990s the fourth generation of audit approach evolved, namely strategic auditing.

'In the traditional detailed audit ['risk-based' audit], auditors' expectations are developed by selecting a random or judgmental sample of accounting transactions; testing the transactions through inspection and validation of corroborating documentation, observation, inquiry, or recomputation; and projecting the adjusted sample amount to a population basis. Expectations developed from details of transaction samples, because they are based on a reductionist process, have inherent shortcomings which can lead to potential decision-making biases... Without a more thorough and unbiased understanding of inherent business risks that threaten the client's business activities, the auditor's ability to judge effectively whether sufficient competent evidential matter has been collected can be hindered' (Bell et al., 1997, p. 63-64).

While the audit risk was reduced to an acceptable level by reduction of the detection risk (in the risk-based approach), the new approach shifts focus to the inherent risk and the control risk.

'Clients ask for an audit that does more than look at numbers. They want to know about potential risks facing their business and to know how they compare against industry best practice' (Jeppesen, 1998).

Fisher (1996) argued that the realised benefits of introducing new audit methodologies stems from the reduction of costly substantive audit procedures. The Big Five audit firms envisage the new approach as aimed towards the integration of audit with other services such as consulting and tax; this holistic approach enables understanding of the strategic objectives of the clients, associated risks, and controls necessary to respond to the risks. The new strategic approach – the business

measurement process methodology – includes strategic analysis, business process analysis, risk assessment, business measurement, and continuous improvement. The overall risk assessment starts with strategic analysis. Strategic analysis is intended to give the auditor an understanding of the client environment and the client's potential for reorientation. At this stage the auditor strives to understand the history of the client, its business strategy, objectives, business risks and planned responses to such risks. In business process analysis, a profound understanding of the key business processes supporting the strategy is aimed for. By the end of this stage risks are identified, as well as processes to control those risks. The risk assessment is a continuous process performed throughout the audit. The traditional conception of control beyond the segregation of duties and functions include looking into diagnostic control systems measuring, and monitoring the accountability of empowered, belief systems, and incentives. Also taking place on an ongoing basis is business measurement, in which additional evidence needed is obtained. Finally, a continuous improvement process takes place. The new strategic auditing supplies the client with new reports: the business profile (i.e. a customised description of the client's business), the business risk profile (e.g. understanding of management's perception, assumptions and judgements about risks), and the gap analysis (e.g. gaps between the client's performance and the benchmarks as defined) (Bell et al., 1997). To sum up the new audit approaches – strategic, business audit – are largely about detecting inherent risks and about evaluating corresponding controls. Inherent risk is redefined and perceived as the risk that the client may not reach its strategic objectives. Where previously financial audit was confined to financial statements, the new approach attempts to audit the client's business and strategy. Further, regardless to the different methodologies used, some structure is inevitably present in audit process.

The knowledge base in auditing is biased towards the client by the focus on adding value to the audit, being aggravated by the direct involvement of the client in choosing the areas to be audited (Jeppesen, 1998). It seems that auditing is constantly being attached to models and frameworks which promise a new operational potential. Power (1997) argued that the common sense view is that audit techniques are accepted by auditors because they more or less 'work' whereas the systemic view is that these techniques and procedures are perceived to 'work', because they have become institutionally acceptable ways of gathering and processing audit evidence (p. 88). The structure of the audit process, however, does not end judgement; rather it relocates judgement and directs it in a certain way. Any audit methodology encompasses both structure and judgement and, therefore, a tension operates between them. As a result of 'compliance pressure' to maintain a high standard of practice, the auditor may not necessarily mediate or/and reflect upon the structure of the process while conducting the audit.

In short, the auditor exists as a professional and as a private individual. The auditor's individual traits – incorporating his/her existence as a professional and as a private individual – and the

dynamics of a wide environment influence the ways in which the judgement strategies in the field are applied. The organisational ‘learning process’ and work place itself predispose in certain ways the auditor’s style of conduct and his/her attitudes to the judgement processes. The individual organises and processes information by relating affective judgement to modes of cognitive styles. The cognitive judgements which manifest themselves in the routine of everyday activities at all stages of organisational systems and processes, are an important determinant of professional performance¹². Hence, it is argued that applied cognitive judgements predetermine the ways in which the auditor organises and processes information while exercising professional judgement and respectively how he/she ‘reads’ audit evidence. Prior literature has recognised the importance of cognitive style in audit judgement and decision making (Bernardi, 1994; Pincus, 1990; Anderson and Marchant, 1989). It seems that the auditors who are more structured and analytical in their thinking will take to codification more readily. Riding and Cheema’s (1991) overall classification of individual cognitive styles, bipolar in nature¹³ is summarised in Table 3.5.

Table 3.5
(W)holist and analytical family of cognitive styles

(W)holist style	Analyst style
<ul style="list-style-type: none"> • Wholist • Intuitive • Diverging • Innovator • Holist • Impulsive 	<ul style="list-style-type: none"> • Analyst • Analytical • Converging • Adaptor • Serialist • Reflective

(source: Sadler-Smith and Badger, 1998, p. 250)

¹² Cognitive judgements relate to cognitive styles, i.e. modes of perceiving, problem solving, remembering, reflective of information processing regularities which develop in congenial ways as around underlying personality traits (Messick, 1984). For more discussion on the phenomenon of cognitive styles see Sadler-Smith and Badger (1998).

¹³ The purpose of bipolar classification of cognitive styles is to present different ways of describing individual styles rather than better ways of thinking. Prior research supports such view (Sadler-Smith and Badger, 1998; Sadler-Smith, 1997; Riding and Pearson, 1994; Kirton, 1989).

Riding (1991) argued that some individuals process information into its component parts while others retain a global overview of information. The former characterises analysts and the latter defines (w)holists or intuitive thinkers. Intuitive thinking seems to be executed in immediate judgements, based largely on feelings, and in the adoption of a global perspective in the decision making processes involving imagination, intuition, receptivity and simultaneity. Analytical thinking is likely to result in judgements, based on mental reasoning and focus on detail (Allison and Hayes, 1996). (W)holists, tend to be over-inclusive in their thinking. For analysts, the separation of the whole problem into parts may mean that one aspect of the problem may be emphasised on the expense of its other aspects, and hence its overall importance exaggerated. Respectively analysts tend to be convergent in their thinking while (w)holists characterise divergent approach to thinking. Sadler-Smith and Badger (1998) argued that intuitive thinkers characterise entrepreneurial and proactive behaviour which translate in their acceptance of higher risks and a resistance to bureaucracy, norms and routines of underline tasks. Analytical thinkers, on the other hand, seem to be good at planning and co-ordinating sets of activities in the pursuit of well-defined and structured goals. Similarly, Kirton (1989) argued that adaptors are those individuals who conform to structure and discipline (i.e. more structured thinkers) while innovators characterise less structured thinking. With relation to modes of individual learning processes Pask (1976) argued that serialists (analysts) take small steps at a time in learning processes. Serial learning is thus facilitated by a reflective mode of a task repetition with step by step changes for incremental development of the individual. Holists however progress rather impulsively by drawing together knowledge obtained across different activities. Individuals may combine styles or aspects of styles to provide an alternative for dealing with a particular problem or facing a particular decision (Allison and Hayes, 1996). Hence, a cognitive strategy in judgement is a function of the interaction of the individual's style of conduct and the underlying situation. Cognitive strategies for audit judgement and decision making are summarised in Table 3.6.

Auditors have different ways of being with regard to audit judgement and decision making processes. Auditors of an analyst style are likely to engage in concrete judgement processes in a manner different from auditors of a (w)holist style¹⁴.

¹⁴ In this study it is assumed that cognitive style of an individual is relatively static over time. Pask (1976) argued that some individuals may employ both serialist [i.e. analytical] and holist approaches in decision making. Those individuals have versatile strategies for action, some which derive from cognitive style and others, which are consciously applied to overcome the weakness of cognitive style approach (i.e. the product of a conscious strategy).

Table 3.6
Applied strategies for audit judgement and decision making

Holistic	Analytical
<i>Unstructured judgement processes</i>	<i>Structured judgment processes</i>
<ul style="list-style-type: none"> • Revision and re-appraisal of existing norms, procedures and constraints of the structure • Creates of overall picture • ‘Big picture’ orientation • Wide horizon • Broad generalisations as hypotheses • Looks for alternatives approaches for decision • Relates ideas to everyday experience 	<ul style="list-style-type: none"> • Working within existing norms, procedures, accepted structure • Gives details in isolation • ‘Black box’ orientation • Narrow horizon • Gives specific hypotheses • Proceeds in stepwise manner

(source: Sadler-Smith and Badger, 1998, p. 250)

Some auditors are characterised by precision, reliability, discipline and conformity to the structure of the audit tasks. They tend to seek solutions applying previously tested modes of highly structured audit methodologies maintaining high accuracy over long spells of detailed work. Other auditors typify undisciplined thinking and tangential approaches to audit tasks and judgement processes. They tend to transcend the structure of audit methodologies and may see well beyond conventional practice of materiality and risk assessments. Those auditors who are capable of deployment of both strategies, depending on underlying circumstances, are versatile. Hence, auditors of an analyst style seem to be ‘at home’ in an audit task which requires planning embedded in a highly structured and logical method. Auditors of (w)holist style, however, would find the demands of a structured audit task at odds with their preferred way of judgement and decision making. In short, auditors who adopt convergent strategies to idea production in audit judgement and decision making are envisaged as more structured thinkers whereas auditors who adopt divergent strategies to idea initiation in audit process as more unstructured in their thinking. Thus, cognitive judgement is one of the key factors,¹⁵ which intervenes between aptitude and ability to predispose audit processes.

¹⁵ Other determinants of audit behaviour include the widely defined environment including the legitimization of the profession, the morale of audit firm, as well as the auditor’s own value system (see Exhibit 3.2).

The decision-making process itself is part of a framework for audit judgement. The decision-making process in the exercise of professional judgement applies to each phase of audit; that is to the stages of planning, evaluation of systems, testing, evidence aggregation and opinion formulation. Judgement assists the auditor right way through all stages of the decision making process. Judgement is present in identifying crucial aspects of the audit, gathering information, seeking solutions, evaluating alternatives and reaching conclusions. The ability to identify the aspects of audit in a holistic manner depends on the auditor's experience and expertise combined with his/her intuition. Professional scepticism should always be present particularly with regard to the acceptance of management representations. The auditor must independently corroborate any significant assertions and representations made by the management¹⁶. The auditor must be aware that often there is no single solution to an auditing question, which leaves a lot of space for individual judgement. The auditor is often overly concerned with the views of the client's management and does not challenge the client to seek for alternatives. Having completed the evaluation of alternatives, the auditor should be ready to reach final conclusions (CICA, 1995). In summary, it is important for the auditor to acknowledge that professional judgement adopts a decision making process incorporating key steps: interpretation of the situation, identification of crucial aspects of audit, gathering information, identification of possible solutions, evaluation of alternatives and reaching the conclusions. Each of these steps requires the exercise of professional judgement so that legitimately defensible decisions concerning financial statements may be reached.

The more ambiguous aspects of individual judgement call for clarification. The focal point in the processes of understanding audit judgement seems to be correlated with one's awareness of self, of dynamism and reciprocity of key interrelated factors in the auditing milieu (as per Exhibit 3.2).

3.6 Summary

Financial statements exist in a context where individual judgements are influenced by many factors. In making a decision in the judgement process, the auditor is subject to various contextual factors relating to practice. These include the regulatory framework (professional standards and guidance, law) to be complied with, factors affecting the quality of the audit (client's firm type, industry, etc.) and factors affecting audit independence (length of tenure, fee level, level of NAS provided to the client, etc.). The elements of the audit judgement milieu incorporate social and contextual aspects of audit practice in its turbulent reality. In this study, the audit judgement milieu encompasses a widely defined environment comprising of (1) the auditing profession with its body of knowledge, legitimacy claims and standardisation processes, (2) government with laws, (3) audit firms with their cultures, tacit knowledge and internal procedures, (4) competitors and

¹⁶ The auditor should not to fall into so called confirmatory trap of searching solely for information to confirm a preliminary hypotheses rather than searching for information which refutes it (CICA, 1995).

pressures to retain clients and pressures for NAS, (5) clients with their powers, (6) financial statements users evoking their reporting needs and quality requirements, and (7) widely defined society with its values and opinions. Within such an environment, elements of the milieu enveloped in accountability relations include features of the particular audit task, the decision making process itself and the personal characteristics of the auditor. The personality of the auditor and his/her expertise and experience are intertwined and interrelated in judgement processes. The ways in which the individual acts are embedded in on-going learning processes, and are adjusted according to ways in which he/she perceives the world. The nature of judgement disseminates complementarily in cognitive and affective dimensions. Thus, the auditor simultaneously exists as a professional and as a private individual. A balance between personal and anonymous, subjective and objective, intuitive and technical, concrete and abstract, constitutes the heart of judgement in the turbulent realms of audit practice. This study focuses on the individual auditor and seeks to gain some insights into his/her 'learning processes' in professional judgement and tacit knowledge of being predisposed to audit. Further, the study unveils tensions between structure and judgement from the practitioner's point of view. New audit methodologies are briefly discussed as a realm of on-going transformation and adaptation processes in audit firms. The widely defined environment of the audit milieu sets the contextual scene in which judgements are made, and remains somewhat opaque since certain elements of the environment affect judgement in ways which are difficult to pinpoint and define.

In this study, the audit judgement process is being considered from the inside, in terms of the logic of auditability and subjectivity, with the aim of contributing to the development of new ways of thinking which might improve judgement processes. The conventional approach of auditing is openly challenged. Hence, alternative ways of thinking about auditing need to emerge in order to develop and refine the techniques capable of supporting the duality of the domain: the technical and social sides of audit practice. A revolving interchange between the profession and society around the issues of independent judgement and responsibilities of auditing suggests that the legitimacy processes in the milieu and a corresponding system of abstract knowledge are social in nature and destined to be continually contested, redefined and modified as social interpretations. It is easy to lose sight of the uninterpreted world, which precedes ontologically the current worldview of the individual.

'The main problem is not whether [people] conform to principles of rationality, but to discover which kind of rationality they are using' (Foucault, 1988, p. 59).

A need for a deeper understanding of judgement processes is one of the key determinants of the post-modern milieu in audit theory. We must not devalue the network of unveiled elements of the audit milieu where independent judgement is embodied in a wider context of social institutions,

structural conditions, and power relations. This wider context thematises the relations between action (judgement) and structure.

‘There are hierarchies of power and processes of legitimation, all of which may remain opaque to the actors which they enmesh’ (Thompson, 1981, p. 157, cited in Llewellyn, 1993).

These elements, attributed to the turbulent environment in which the auditor exists, extrapolate beyond statistical inquiry. The explanatory component of independent judgement calls for further clarification by reference to the relationship between action and structure inhabiting a wider context. Hence, investment in an institutional rationality of the audit process which does not threaten the discourse of individual judgement needs to be sought. For that reason, this study is embedded in an interpretive approach and attempts to contribute to understanding audit judgement through emphasising the social and contextual aspects of audit practice. Interpretive dimensions of auditing is the subject of discussion in the following chapter.

CHAPTER 4

Interpretive dimension of auditing: Hermeneutic turn in a methodological framework

4.1 Introduction

Throughout the social sciences, the last two decades have seen the emergence and establishment of an interpretive and hermeneutic research agenda which seeks to describe and illuminate the connections between subjective meanings and practices, thus going beyond traditional positivistic paradigms which confidently asserted the possibility of describing an objective reality¹. This process can be discerned in accounting and auditing research agendas (Hines, 1989; Hopwood, 1983).

Hermeneutics can be envisaged in at least three different ways: (1) as an auxiliary science providing the rules for explaining ancient texts, i.e. recovering meanings, (2) as a general problematic of understanding, i.e. interpreting meanings, and (3) as the ontology of the individual who lives giving meanings to his/her world²; the world envisaged as the horizon of individual interpretations. 'Being' designates the interpretation of the ways in which the individual understands him/herself within 'being'. The route of interpretation may lead to an understanding not only of self, but also of the structures of 'being' in which life is embedded (Leeuwen, 1981, pp. 68 and 70). Hence, the present study, drawing on the general problematic of understanding (point 2) and phenomenological hermeneutics (point 3), in particular Ricoeurian hermeneutics, explicates the consequences of individual interpretations into the wider social spheres of audit practice.

Hermeneutic phenomenology can be adopted as a methodological framework in interpretive research where human practice is envisaged as simultaneously reflecting and shaping its own structures and ideas. Hermeneutics constitutes a 'methodological stance' rather than an explanatory medium through which research findings are interpreted. Thus, hermeneutics proceeds from a less encompassing position than grand social theories which have a tendency to unnecessary abstraction (Ahrne, 1990, p. 19).

¹ In a positivist approach the subject and the object of the research is conceptualised as observations and records concerning the object of the research.

² Hermeneutics, envisaged as the ontology of the individual, was inspired by the phenomenology of Heidegger. In this study, hermeneutic phenomenology is represented by the work of Ricoeur.

Llewellyn (1993) states, with reference to hermeneutics that:

'[T]here can be no clear-cut distinction between a 'methodological stance' and the adoption of fully developed social theory as a theoretical framework³; the latter position tends to substantiate the initial theory rather than producing new knowledge' (Llewellyn, 1993, p. 234).

Hermeneutics serves as an appropriate research vehicle for this study in that its methodological focus is the work of interpretation; how the individual makes sense of and interacts dialectically with the surrounding structures and realities. By refuting the positivistic division between 'subjective' and 'objective', the phenomenological perspective does not pre-empt the ways in which social reality is constructed, as with grand social theories. It rather seeks to shed light on the processes by which new perspectives and new knowledge are created by the individual through the description of the subjective and the ways in which the objective is apprehended.

The auditing and accounting literature has explored aspects of the hermeneutic tradition. Francis (1994) discussed audit judgement as a hermeneutical practice; Llewellyn (1993), Willmott (1993) and Boland (1989) discussed hermeneutic contributions towards the paradigm of accounting research; Lavoie (1987) examined the application of hermeneutics to an understanding of accounting as the language of business.

The present study, by taking a hermeneutic turn – a particular way of conceptualising audit practice in the social world - seeks to enhance the understanding of meanings associated with professional praxis. In particular, the meanings of audit judgement processes are sought through interpretations, where these meanings are expected to be inferred by auditors themselves. Thus, the study denies an objective-subjective dualism, and involves an appreciation of the close intertwining of a social practice and of the language embodied in a particular field of practice (Taylor, 1979).

This chapter presents the work of auditing as a hermeneutic practice. The remainder of this chapter is organised as follows. Firstly, the role and significance of hermeneutics is presented. Secondly, drawing upon Ricoeurian propositions, the parallels between the means of interpreting text and that of human practice are made. This section discusses implications of the hermeneutic turn as a methodological stance. Thirdly, the limitations of the Ricoeurian framework are presented.

³ I.e. work of Foucault, Gadamer, Habermas. (See Stewart, 1992; Macintosh and Scapens, 1990; Laughlin, 1987).

Following that, drawing on organisational theory, a contextualisation of individual practice is provided in order to integrate subjective understanding with an analysis of more objective conditions of that practice, which simultaneously enable and constrain the individual endeavour. The subsequent section demonstrates that auditing can be envisaged as socially constructed hermeneutic practice. Finally, standardisation processes in auditing are presented, in particular with regard to audit operational approaches. This section demonstrates the 'downside' effects of tensions between individual judgement and structure in the audit process in the interrelated 'socially constructed' and 'standardisation' contexts.

4.2 Insights from the theory of hermeneutics

Hermeneutics constitutes a mode of discourse and conceptualises human action in terms of a text analogue, so that hermeneutics may be subsumed as an interpretive methodology. Historically, hermeneutics encompassed the notion of the search for authentic knowledge with the attempt to recover the authenticity of biblical texts where an original meaning had been lost through successive translations into different languages, and embedded in different cultural contexts. The sense of the word 'hermeneutics' has evolved over the years and the usage as 'recovery of a meaning' gave way to the use as 'interpretation of a meaning'⁴. Nowadays, hermeneutics seeks to interpret the 'situated practices of the individual' (Scapens, 1992). Hermeneutics generalises all understanding as a subjective interpretive enterprise of responding to the distance that constitutes individual being in the world. It is this focus on individual nature in the world which defines hermeneutics as being concerned with both 'how we are' and 'who we are' (Gadamer, 1991), that is from epistemological to ontological inquiry. Taking a hermeneutic turn requires approaching the social world as a text that is alien and unfamiliar; a text in which significance and meaning will emerge only through interpretation (Boland, 1989). Hence, as a theory, hermeneutic phenomenology draws parallels ontologically between aspects of social action and certain features of a text, and methodologically, between the understanding of social action and the interpretation of a text (Ricoeur, 1981, p. 197). In other words, written theory does not stand apart from actions as an objective impersonal essence of subjective and personal performance. Rather, theory and action are bound and both emerge from a common field of language practice. Hence, the hermeneutic problem centres on action as related to the essentially linguistic character of human experience and behaviour (Jervolino, 1996, p. 63). The Ricoeurian version of hermeneutics, adopted in the present study, focuses on social practice as an active relation between the realms of ideas and the realms of real, material objects (Sayer, 1992, p. 205), not being solely concerned with the explication of subjective meanings. Ricoeurian hermeneutics also rejects the notion that explanations are inappropriate in social sciences (Llewellyn, 1993, p. 234). The existence of structures, through which many unarticulated conditions encompass human practices, invokes the

⁴ For more discussion on the origin of hermeneutics see Bauman, 1978.

need for explanation as well as subjective understanding. This problem can be envisaged as reflection on the fragility of language and socio-political action (Jervolino, 1996, p. 76), implying that the individual needs to strive to 'win' meaningfulness for his/her action.

Human practices, no less than literary texts, display a sense as well as a reference and possess internal structures as well as projecting a possible world, a potential mode of individual existence, which can be unfolded through the process of interpretation. Thus, the individual strives to construct knowledge about the world through participation in forms of life. This construction of meanings to the words and to propositions is grounded in the action of daily practice. Ricoeur (1981) draws on Gadamer's development of philosophical hermeneutics, which constitute a general framework for articulating how individual understanding emerges through engagement with the particular traditions and social practices in which one is enveloped. Such a context may enable standardisation of a particular social practice.

'That which has been sanctioned by tradition and custom has an authority that is nameless...always has power over our attitudes and behaviour' (Gadamer, 1991).

Gadamer (1991) claimed that the world of daily life confronted by the individual is alien, and therefore in need of interpretation if he/she is to engage in purposive action. He further argued that interpretation of the world is grounded in the tradition which both prejudices and allows one's ability to understand the world. Ricoeur (1974) stated that hermeneutics has to do with

'[T]he continual exegesis of the significations that come to light in the world of culture; [...] works, institutions, and on the other hand, that interpretation is related to symbolic structure' (Ricoeur, 1974, p. 12 and 22).

Hence, hermeneutics implies a reflective or existential moment of explicit or implicit self-understanding. For Ricoeur an understanding of the other coincides with an understanding of the self and of 'being' (1974, p. 51). Individual capacity of thinking and being creative tends to be denied in favour of the power of anonymous structures of the language governing one's consciousness of the world and of him/herself. To understand individual behaviour is to understand the structures that constitute his/her language, the network of myths and texts that constitute his/her culture, the social and institutional structures that constitute his/her society (Leuween, 1981, p. 75).

4.3 Social action as text

The hermeneutic discourse of action recognises that human practice itself projects a mode of being in the world, a mode which can only be grasped in a 'discourse which qualifies itself as interpretation' (Ricoeur, 1981). Action may be regarded as text, insofar as it may be objectified in

a way that embodies forms of distancing which constitute the semantic autonomy of the text. For just as a text is disconnected from its author, so too human practice becomes detached from the individual and develops consequences of its own. Ricoeur (1981) claimed that unless the connection between the understanding of social practice and the interpretation of a text is established, the links between hermeneutics and interpretive methodologies remains tenuous. He unfolds the distinctiveness of discourse in terms of an internal dialectic between event and its meaning. A word becomes a ‘trader’ between the system and the act, between the structure and the event (Ricoeur, 1974). To develop the analogy between the interpretation of texts and that of human action, Ricoeur (1981) points to ways in which the meaning of an action becomes detached from the event of its performance, therefore becomes objectified, and thus an appropriate focus for an act of interpretation. These axioms for the understanding of a social practice as a text-analogue are summarised in Table 4.1.

Table 4.1
Ricoeurian hermeneutic propositions

Proposition 1	The fixation of action The ‘sense-content’ of action and text must be drawn out; comprehension is not immediate or unmediated.
Proposition 2	The autonomisation of action The text or the action has both personal and social significance, its social dimension implying the possibility of institutionalisation.
Proposition 3	Relevance and importance The text or the action may transcend its encompassment within its initial circumstances and develop meanings in other social contexts.
Proposition 4	Action as an ‘open work’ Textual interpretation and social understanding are essentially ‘open’ in nature.

(adapted from Llewellyn, 1993, p. 238)

Firstly, human practices and written texts can be analysed for their ‘sense-content’ encompassing anticipated intentions and motivations, thereby including a pre-understanding of rationale and contradictions to those practices (Ricoeur, 1981, p. 204). Each practice has a prepositional and identifiable content in the form of structures of locutionary acts, i.e. a coherence between the practice and individual meanings of the envisaged situation. Hence, the purpose of text-action analogy is to find coherence between social practice and the meaning of its situatedness for the individual. Secondly, practice and text are capable of becoming detached from the individual who

performed or wrote them and can attain a social dimension, developing consequences of their own (Ricoeur, 1981, p. 206). In that sense, practice can be understood as a social product; hence the practice is socially constructed. The social nature of an individual action implies that its antecedents are not fully encompassed by his/her personal motives. In any social setting, systems of meanings conform to work practices.

‘Meanings attributed to work practices are not just in the minds of those engaged in them, but depend on what they mean in society’ (Sayer, 1992, p. 30).

Changes in work practices are therefore accompanied by changes in their meanings. Thus, behaviour cannot be understood in isolation from the structure of social rules, i.e. standardisation, by which it is regulated and from which it derives its meaning. Decisions and their fulfilment are based upon these existential structures to which the individual consents. Both the rules which define the socially constructed content of human action and the structures which shape the scope and the power of the individual endeavour present as objectifications. These objectifications negate an equating of the antecedents of practice with the personal motives, reasons, and intentions of the individual. It is a process which generates the links between systems of meanings and material practices, so that what practices are, is dependent partly on what they mean in a wider environment. Practices become objectified and present as a social reality which simultaneously enables and constrains individual action, where hierarchies of power, processes of legitimation, and social structures can be somewhat obscured⁵. In a similar way, auditing practice depends on what it means in the society through the process of generating the links between systems of meanings and material work practices. Thus, action as a text can contribute to an understanding of the emergence of institutionalisation, where the object of social science is rule-governed behaviour (Winch, 1958). Governing rules are not superimposed; they are constituted of meanings as articulated from within the instituted work. This could be envisaged as a kind of objectivity which proceeds from the social fixation of individual behaviour (Ricoeur, 1981, p. 207). Thirdly, practices may escape their initial definitions and circumstances and may develop meanings in other social contexts. The meaning of an important event exceeds, overcomes, and/or transcends the social conditions of its production and may be re-enacted in new social contexts (Ricoeur, 1981, p. 208). Finally, human action as a text is an ‘open work’.

‘[W]ork does not only mirror its time, but opens up a world which it bears within itself’
(Ricoeur, 1981, p. 208).

⁵ Some antecedents and consequences of practice are known to the individual but some of the conditions for social action, such as hierarchies of power or processes of legitimation, may remain unrevealed (Rabinow and Sullivan, 1979).

Thus, the interpretation of practice is an integral and necessary condition for the continuity of social life. Fresh significance can always be placed on an event by invoking a new and different frame of reference – interpretations which determine new meanings. Any action can receive a new relevance and interest by being viewed from a different perspective.

In short, Ricoeurian propositions assume that individual interpretations refer to values and beliefs within the perceived ‘contextuality’ of action. ‘Contextuality’ is equated with the setting of the action and determines individual awareness of the processes and structures which are used to orient and make sense of the enacted action (Giddens, 1987, p. 215), i.e. a realm of the ‘first-order’ construct in the social world. The ‘sense-content’ of action is not confined to individual reasons, motives and/or values, and lies in its nature as a social product. Consequently, the ‘second-order’ construct can be constructed using language, which reinterprets the action, events and experience of the individual (proposition 2). However, as practice is essentially an ‘open work’ (proposition 4), and individuals make and know themselves and their world through social practice, the individual may appropriate the emerged ‘second-order’ construct into the ‘first-order’ construct and so on.

The notion of human practice as a social product is associated with the post-structuralist notion of the ‘decentring of the subject’ (Giddens, 1987, p. 88), evoking that a legitimate account of events which may differ from or transcend the understanding of the practitioners themselves can be constructed. Hence, such constructed research enables reflection upon both the pre-understanding of the author and the ‘first-order’ construct of the research subject.

Ricoeur’s justification for the possibility of treating human practice as a text is built upon two arguments. His first argument is concerned with the fixation and inspiration of human action. He argues that the process of action is characterised by an ‘intentional exteriorisation’, which facilitates the detachment of the meaning of the action from the event of its performance. Individual performance becomes in a sense depersonalised by a rule-bound reality enveloped in organisational and societal norms. One of the traits which characterises the text as work is its production in accordance with rules that defines its literary genre. ‘To master a genre’ is ‘to master a competence’ which offers practical guidelines for ‘performing’ an individual work. His second argument concerns the emancipation of human action from the circumstances and participants of the underlying situation. As a text is free from reference restrictions, so too the importance of action transcends its relevance to the original circumstances of its production. An ‘important action’ can develop meanings which can be actualised or fulfilled in situations other than the one in which this action occurred (Ricoeur, 1981). The ‘open’ nature of human practice points to an inevitability of the hermeneutic circle of understanding and explanation. As an event, discourse is an open end, and in principle, an unlimited process of creating meaning. The openness of ‘language

as discourse' is evident. Firstly, discourse refers away from itself and becomes a claim of expressing a view on the world, or affirming something about reality. Secondly, discourse is an illusionary act, an act by which some question, statement, or wish is expressed (Leeuwen, 1981, p. 78).

Hence, the processes through which individuals build understanding about the world is an interplay of embeddedness in tradition and of the world perceived as a text; this interplay refers to a hermeneutic circle. The hermeneutics of understanding and explanation describe the processes through which the subject and the object of the research become somewhat more aware of the concepts and ideas guiding individual thinking processes. The hermeneutic circle recognises that in the understanding of a text there is a dependence on a theory of the whole to understand the parts, and, at the same time, there is a dependence on a knowledge of the parts to comprehend a theory of the whole (Boland, 1989). Gadamer (1991) argued that this hermeneutic circle can be perceived as the underlying structure of understanding.

'The circle, then, is not formal in nature, it is neither subjective nor objective, but describes understanding as an interplay of the movement of tradition and the movement of the interpreter. The anticipation of meaning that governs our understanding of a text is not an act of subjectivity, but proceeds from the communality that binds us to the tradition...Thus the circle of understanding is not a methodological circle, but it describes an ontological structural element of understanding' (Gadamer, 1991).

As stated earlier, hermeneutic thought is not concerned with a question of absolute knowledge or method, instead it is concerned with a question of what kind of social practices achieve authentic and good understanding through which individuals make and know themselves and their world. Auditing may be envisaged as such a practice. Taking hermeneutics as a research methodology has its consequences and implications. Firstly, the hermeneutic circle allows more awareness of the concepts and ideas which guide individual thinking, as well as of inherent emancipatory or constraining qualities. Ad hoc interpretive skills and some kind of pre-understanding of the event govern any 'reading' of an event in the social world. The pre-understanding of the researcher and the researched is conditioned by their social belonging (Llewellyn, 1993, p. 239). A heightened awareness of such pre-understanding leads the individual to strive to attain more adequate conceptualisations through both critical reflection and an engagement with their frames of reference. Subject and object are thus 'mutually implicated' in commitment (Ricoeur, 1981, p. 57). Secondly, the hermeneutic circle encompasses interpretive research where there is neither an obvious starting point, nor obvious boundaries to the problem. For the content of narrative analysis see chapter 5. Such constituted work may be further the subject of appropriation, and from there an enacted change may emerge.

4.4 Beyond Ricoeur's hermeneutical point: The medium of institutions

The processes of creating meanings are influenced by the socio-cultural position and experiences of the practitioner as well as the references of the context in which the act of interpretation takes place. Ricoeurian hermeneutics brings some limitations, in particular with regard to the contextualisation of structures in socially constructed practices. Human practice needs to be situated within the wider social context of social institutions and social conditions through the thematisation of the relation between action and the structure. In particular, the exercise of power cannot be easily accounted for in the analogy between structure of social spheres and structure of language. Thus, the explanatory component of the socially constructed practice may be further clarified by reference to the relation between action and structure through the medium of institution. Knowing how to act in specific contexts, is, among other things, knowing the range of possible actions which are permitted by the relevant institution (organisation), and which provide the individual with general parameters for acting in new and unanticipated situations. Schemata become inscribed in the desires, inclinations, attitudes and beliefs of the individual, constituting the sphere of values as roots of the action. This process of inscription relates to the notion of 'habitus' defined by Bourdieu as 'the durably installed generative principle of regulated improvisations' (Bourdieu, 1977, p.78). Within the realm of the post-modern economy it is easy to lose sight of an implicit, uninterpreted world which ontologically precedes the individual's current worldview. Such schemata, however, may enable the negotiation of routines to novel circumstances of everyday life; either transmitted through a trail, an imitation, and/or an error.

Human practice embodied in the medium of institution can be a creative and potentially transformative process. In certain circumstances the individual may act in a way that directly transgresses an institutional schemata, thereby placing his/her own career and/or the continuation of the institution at risk. Insights into institutional structures may induce individuals to reflect upon the circumstances in which they act, and may enable them to grasp 'enshadowed' conditions of their existence.

Hence, the understanding of motives and actions of the individual as social constructions implies the embeddedness of their initiative in a wider socio-political milieu. Hermeneutics, through the interrogation of subjective and objective realms of experience, focuses on the analysis of the experience of the individual embodied in social practice and the analysis of the objective structures that make this experience possible (Bourdieu, 1988). The present study, somewhat dressed in interpretive hermeneutics, is aimed to integrate subjective understandings with an analysis of more objective conditions for social practice, which simultaneously enable and constrain an individual endeavour (proposition 2).

4.5 Interpretive auditing

In the present study, auditing practice is envisaged as a socially constructed hermeneutic practice. Firstly, the auditor situated within the practice tradition on a daily basis audits the client, i.e. interprets the 'representational text' of the client's operations, that is the financial statements. Audit is then a communication process with the medium of communication being a written text. Drawing on the tradition in auditing, the auditor strives to understand and interpret the 'economic text' narrated by the financial statements and to evaluate whether this is a *true and fair view*, i.e. the assertions are made in narratives of the client's view of the economic reality. The auditor judges and attests to the validity of financial statements, which contain stylised interpretations of the fiscal health of the client's company. For the auditor, judgement about the validity of financial statements is formed and translated into an audit opinion. By doing so, the auditor reassures the public that these interpretations are trustworthy. Secondly, the auditor, drawing upon the tradition of auditing practice, refers to this tradition as auditing standards and guidance. The meaning of these standards is itself a hermeneutic question, asking what tradition is and what it requires of the individual in the particular audit engagement. Hence, auditing as interpretive practice shapes the individual understanding about social life. Thirdly, the auditor as an interpreter situated in the audit process is distanced from the object-text to be interpreted. That is, the auditor is not 'on location' and cannot see when and where the underlying events of the client's accounts to be accounted for have occurred. The auditor's interpretive judgement on financial statements arises in response to this distance. The auditor processes evidence (data) according to his/her individual experience of the client where meanings are always context-dependent. Accounting explanations objectify performance and disconnect the auditor's action from his/her personal motive. The hermeneutic understanding appears in another important way in the auditing tradition, i.e. the emphasis on the auditor's scepticism as his/her genuine stance. The sceptical auditor challenges his/her own preconceptions about the economic text of the client's accounts during the processes of interpretation and understanding being perpetually sensitive to financial statements' text alterations. These alterations of 'economic reality' may result in the state of financial statements not being able to be presented. This may occur in the situations when the auditor doubts the integrity of the client's management or quality of the client's control systems. Hence, the end-product of the audit process, an auditor's opinion, and the means of producing the audit are mediated by the individual auditor. This situates the auditor within the context of hermeneutics.

The auditing profession, like any other profession, has its particular professional and social significance, simultaneously reflecting on the societal needs and shaping its own distinctive structures and ideas. Drawing upon the social understanding of audit practice being 'open' in nature (proposition 4) implies the possibility of its institutionalisation. Auditors, as members of a profession, co-operate in carrying out designated tasks within specific social contexts. These social contexts include both an externally imposed structure and internally acquired behaviours. The

externally imposed structure contains the interrelated components of organisational design including technology, which is written into the work environment. The external structure can be illustrated by the examples of compliance practice where the system of meanings is governed by the conventions and rules (professional standards and legislative requirements). The institutionalisation process in the auditing profession can be envisaged as the accumulation of 'linguistic objectifications' (Ricoeur, 1981, p. 56). These objectifications order all organisational routines of the audit firm encountered in the pragmatic motives of everyday practice. The existence of pragmatic motives embedded in day to day operations ensures that whilst a context, culture, or a way of thinking allows the individual to 'go on' in the work, it is likely to continue (Giddens, 1984). The individual strives to construct knowledge about the world in the participation in forms of life, and seeks for meanings to the words and propositions grounded in daily action. Within the audit context auditors communicate, interact, and develop symbolic meanings using certain validity claims. Firstly, the audit can be validated as the most efficient and effective means for attaining the end; getting the job done. The auditor makes these claims in the audit engagement to both the client and other auditors. Secondly, the audit can be envisaged as 'correct and proper in accordance with relevant norms'. The auditor makes such a claim in implementing accounting and auditing standards as they represent socially acceptable modes of behaviour. Thirdly, the audit can be validated as constituting authentic subjective action, which relates to subjective judgement in the sense that the auditor holds himself/herself to be 'genuine' (Dillard, and Bricker, 1992, p. 218). In that sense, norms, traditions, and values are the basis for individual internal representations, which provide for an understanding of social discourse.

Levi-Strauss (1969), from a structuralist perspective, argued the importance of demonstrating not how the individual thinks in myths, but how myths operate in the individual's mind without his/her awareness of this fact. These myths, existent in auditing practice, represent conformance to daily routine operations which are objectified by the level of abstraction embodied in standards and guidance. Both the profession and the audit firms propagate a symbol of the 'ideal of the service' in the hope that it convey to auditors' shared meanings. The judgmental character of auditing cannot be solely grounded on a reliance on structured methodologies, since conformance to the structure does not end the auditor's understanding. Auditors make and know themselves and their professional world through work practice and through the exercise of individual judgement. The auditor on the job is situated in the context of intensive, on-going interactions with other members of a team, the firm, the client's organisation, and the profession. Further, judgement has an irrational element including personal knowledge of (1) the breadth and impact of individual actions external to self or the institution(s) one is identified with, and (2) the breadth and impact of individual actions internal to self (e.g. empathy). The individual auditor is able to process the symbols of the 'ideal of service', if not as a wholly free agent, then as an interpreter. In such ways the individual strives to reveal the profession's assumption that it controls the terms on which the

individual relates to the organisation (Cohen, 1994, p. 93). Organisations are creations of human action since within these very organisations individuals often experience their world of lived experiences (Ricoueur, 1981). Hence, the judgement process is enveloped in the hermeneutic dynamics between the auditor and the evidence, more precisely, between the auditor's pre-understanding of the circumstances of the audit task and the audit evidence.

Hence, alternative ways of thinking about auditing practice need to be constructed in order to properly apprehend the dynamics of practical interventions in the world, in order to supplant current 'orthodoxy' in the practice (orthodoxy in auditing manifests itself in the conformity to standardised audits). Auditing practice envisaged as socially constructed hermeneutic practice is one of such alternative ways.

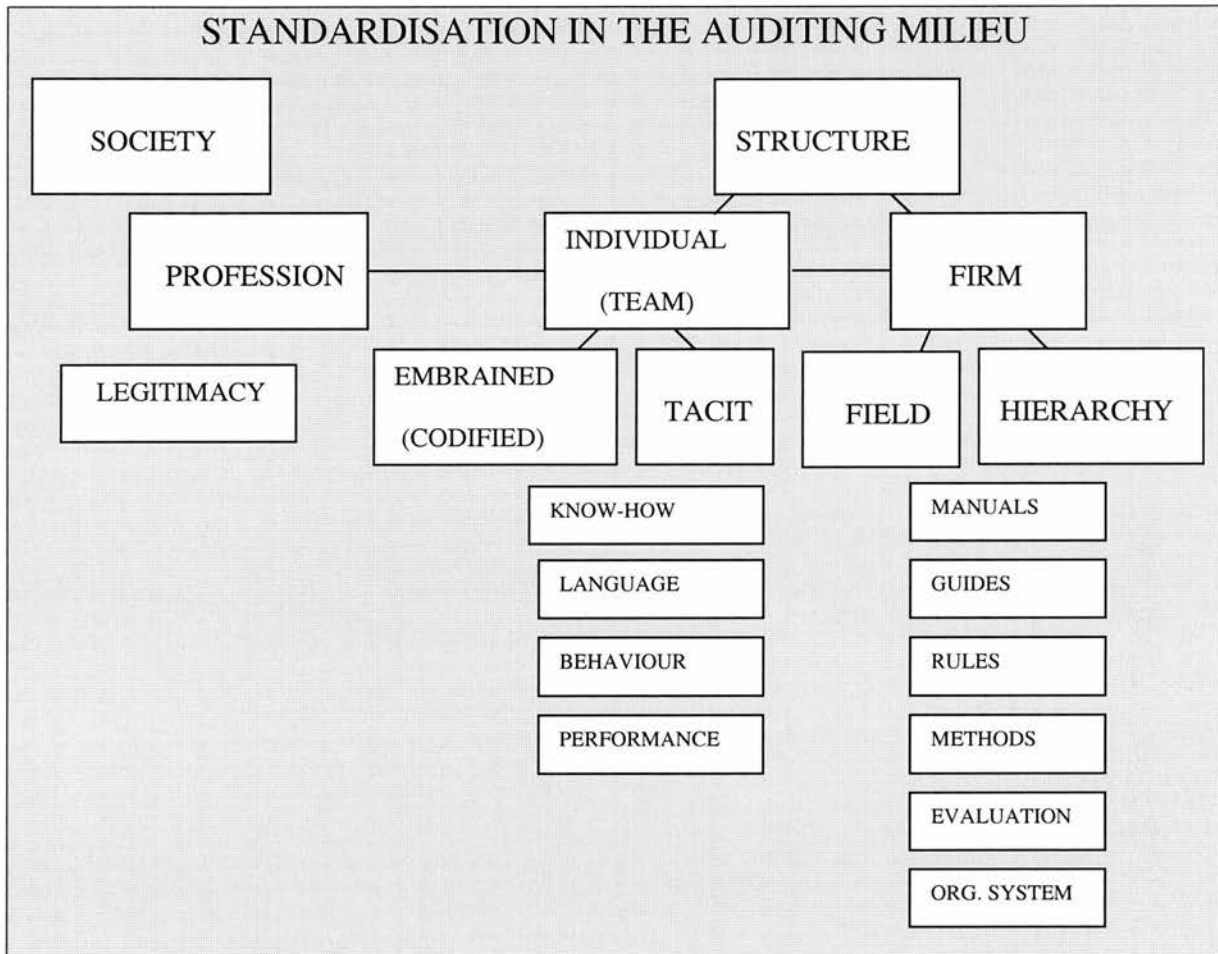
4.6 Standardisation in the auditing milieu and the debasing of practice

The auditing profession, as with other professions, relies on knowledge standardisation; the means by which knowledge may be appropriated and replicated. The process of standardisation in the auditing milieu could be looked at through the prism of legitimation processes (i.e. codification) and through the prism of the form (i. e. structure). The objective of different forms of standardisation is to bring uniformity to behaviour and the individual skills of the professional by using standardised techniques of conduct and respectively to balance judgement and expertise. Structure can be envisaged as *the individual* category (i.e. cognitive and tacit processes of the individual), *the team* category (i.e. cognitive and tacit processes of the individuals working on the same task), and *the firm* category (i.e. its hierarchy and authority). The systematisation of structures in the auditing milieu is presented in Exhibit 4.1.

The profession exerts control over bodies of knowledge and defines what that knowledge consists of. A codification process can be envisaged as (1) a first stage in the process of deskilling of the individual (Morris and Empson, 1998) and/or as (2) legitimation process with the opportunity for the intensification of judgement (Bourdieu, 1988). Perceptions of organisational reality are fragmented and subject to individual interpretations. The ways in which events and actions are interpreted define the essential performance environment and portray the base on which judgements are made. It can be assumed that factors, which favour the perceptions of legitimacy, lean to societal expectations and organisational behaviour⁶ (Carpenter et al., 1994).

⁶ Carpenter et al. (1994) argued that audit judgement as a social behavioural phenomenon is strongly influenced by the social context of the particular audit firm.

Exhibit 4.1
Standardisation in the auditing milieu



The institutionalisation of the profession can be envisaged as a process of creating reality, wherein elements of formal structure are simultaneously legitimated and a source of further legitimation. In this study, legitimation is intertwined with professional reality. The auditing profession produces and provides rules and procedures, which establish and enhance its legitimacy and a survival prospect. These standards and procedures bring the audit activities within the realm of impersonal techniques performed by individuals. By adapting statistical and econometric methods to the auditing context, audit firms acquire ways to create their own structures and methodologies. In effect, audit firms modify the abstract system of knowledge in response to societal forces which initiate and end legislation changing the current of legitimation (Carpenter et al., 1994). Through such means, abstract notions of economic discourse are made calculable and knowable. In other words, abstract categories, such as objectivity, effectiveness and efficiency come to be translated into, and held to require, the 'calculative apparatus in accounting' (Miller, 1994, p. 3).

Knowledge codification acts as means to utilise (the leveraging of) expertise and enable deployment of less experienced individuals on the client's assignments. Knowledge helps in the framing of audit issues, procedures and anticipated outcomes. Structured auditing methodologies, however, do not flow spontaneously from the minds of neutral and detached individuals. It is a result of tailoring to be applied to modify and support the goals of the profession. As a result of these legitimisation processes, applied judgements contain the bureaucratic practice where expertise comes from some external and objective sources. Professional knowledge becomes encoded within the organisational structure and therefore decision autonomy rests not with individual auditors but with those who structure their roles.

Regulatory structures of accounting bodies threaten the concepts of neutrality and independent judgement in audit practice. It is the professional institute that controls the entry to the auditing profession and acts as repository of knowledge on which jurisdiction is claimed over certain areas of performance and client's problems (Abbott, 1991). Documented knowledge (i.e. standards, manuals, guidance) is formally held out as a basis for professional judgement. The significance of such documents should not be underestimated; the notion of professionalism in accounting and auditing has increasingly been equated with the standardisation and regulation of professional conduct (Hopwood, 1998). Standards are useful in establishing both the professional claims and the body of knowledge with which auditors claim to work.

By standardising and normalising judgements and encoding them in forms of organisational structure (e.g. operational procedures in manuals), by specifying thresholds of such judgement errors as acceptance or rejection of the client's financial statements, etc., the power is transferred from the auditor to the administrative component of the audit firms. Each audit firm adopts its own rules and conventions to which govern audit process. For instance, the preparation of working papers is highly structured including its requisite formats and terminology. Such standardisation facilitates a review process through the staff's familiarity with the content and form of these papers, enabling notions of efficiency and effectiveness. Further, the auditor 'learns' that written working papers can be used as evidence against him/her in an eventual court case (Rich et al., 1997).

'The institutionalised professionalism is symbolised by the comportment of the auditor on the job. The working routines of the auditor are an important way to symbolise and establish his/her legitimacy...it seems somewhat ironic that the very qualities that create the impression of professionalism and commitment when viewed from the frontstage seem to remove individual discretion when viewed from the backstage' (Pentland, 1993).

Since legal processes rarely question the body of knowledge as such, defensibility is not only a matter for the individual auditor, but also involves the development of a body of procedural knowledge, conformity to which counts as executing *best practice*. In such sense, justificatory discourses and technical methods displace judgements. In effect, audit seems to be largely treated as a 'black box' exercise (Hopwood, 1996), a technique of verification of accounts and/or checking the compliance with a priori established criteria (Flint, 1988).

The knowledge base of the audit process, however, remains obscure. Firstly, although knowledge flows in the audit firms may be upward and lateral, from junior to senior staff via network of standards, some knowledge ad hoc does not seem to be easily codified without deterioration of its content and context (Hopwood, 1998). Knowledge and experience of fraud cases is content and context dependent; hence, not facilitative of structured inquiry. Secondly, although audit process for all its density of operational procedures is interactive and judgmental, there is no clear conception of 'authentic' process, independent of the system of knowledge in which judgements are embedded. The auditor perceives that the nature of the assurance provided by the audit process is elusive and problematic. (Power, 1997, p. 36) The auditor attempts to overcome this obscurity by appealing to the authority of his/her own judgement determining what is *reasonable practice*. Practitioners discuss the merits of structured and unstructured audit approaches (e.g. Sullivan, 1984; Francis, 1994). These were, and continue to be, the concerns that audit could become a merely mechanical practice, threatening the status of the individual auditor. Further, the Big Five audit firms have been periodically changing their entire audit approaches, and these changes are ongoing. These firms have a particular power over operational independence of those individual auditors who often prefer inventive and methods based approaches on broadly defined principles; that is, the 'big picture' thinkers. Lastly, it seems that regulations become political decisions where proponents of this processes emphasise that markets favour those with existing resources or/and position in the society (Cooper and Sherer, 1984).

The changes in a business environment and a growing litigation drive a demand from the audit firms for additional regulations in the forms of standards and procedures. The official procedural knowledge base of auditing, although evolving (often in response to corporate failure and scandals), maintains an institutionally credible system where central to legitimation claims of professional bodies and audit firms is the presentation of auditors as bearers of professional knowledge and professional standards (Grey, 1998). There are concerns that audit becomes a more 'regulatory compliance' product at the expense of space for professional judgement, as each crises pushes it in this direction. Hatherly (1996) argued that existing regulatory structures in the UK tend to overvalue the audit approach based on objectivity of the formal and structured process. Operational procedures express a particular manner of making things auditable and of securing acceptance that the system of auditing works. An extensive body of procedural guidance provides

the benchmark for *best practice*. Hatherly (1996) argued that the performance of the audit firm is increasingly judged by the profession and by the audit firm itself (in terms of a process and compliance with a process), and consequently compliance with a process seems to be more visible and demonstrable than judgement. Regulation seems to reshape the meaning of audit from a professional judgement for shareholders into a compliance statement for the regulator. Hence, legitimisation via process inevitably displaces legitimisation through reference to judgement. In effect, 'good' auditing ends as conformity to agreed procedures over time.

'We live in a compliance culture where people are driven to look at the rulebook to ensure that they have completed the checklist, rather than to think outside the box. The auditor experiences a challenge to look outside the square [i.e. the 'black box']...at the information and decide in his/her judgements it is *true and fair*, or whether it is merely a compliance of 'how does it fit the law' (Percy, 1999, p. 6).

The debasement of practical reasoning in auditing can be illustrated by the structure – judgement metaphors which characterise and differentiate audit operational approaches. Structure does not end judgement, rather it reallocates judgement and directs it in a certain way. In this respect, any audit methodology contains both structure and judgement, and a tension operates between them. The rhetoric of structure may affect reflexivity and the awareness that there is always judgement and subjectivity in audit. It fosters the illusion that a science-like objectivity can be achieved. Cushing and Loebbecke (1986) describe a structured audit methodology as

'...a systematic approach to auditing characterised by a prescribed, logical sequence of procedures, decisions, and documentation steps, and by a comprehensive and integrated set of audit policies and tools designed to assist the auditor in conducting the audit...the policies and tools are comprehensive in the sense that they cover the entire audit process, from initial acceptance of the client to the ultimate issuance of the audit opinion' (p. 32).

Power (1997) argued that audit techniques are accepted by auditors because (1) they more or less 'work' and (2) are perceived to 'work' since they have become institutionally acceptable ways of audit. The advantage of structure centres on two themes, economic efficiency and litigation protection. The argument for the economic efficiency of structure results from the standardisation of what is presumed to be an inherently standardisable and routine task. With the deregulation of the audit market, i.e. price competition and increase in auditor switching, the efficiency of the audit became a serious economic concern for the audit firms. The argument for structure reducing litigation risk is similar in that it again focuses on cost savings to audit firms. The systematic character of structured audits is perceived as reducing the risk of audit failures and providing documentation that the audit firm has conformed to auditing standards and guidance, and hence is not negligent in production of a *true and fair view*. On the other hand, unstructure is a code word

for subjective judgement, and structure is being opposed to the tradition of professional judgement. The traditions and norms historically valued the individual auditor's subjectivity and professional judgement. Nowadays audits are presumed to be homogeneously sufficient across contexts to benefit economically and technologically from the kind of universality and standardisation embedded in rule-bound reality (Francis, 1994, p. 253).

It is important to emphasise that methodology should be of service in audit; that is, used as a tool which underpins but not overwhelms the practice. Instead, the auditor is increasingly in the service of decision aids and structured audit methods. Cushing and Loebbecke (1986) identified trends in the auditing environment facilitating structure in audit practice. These are: (1) severe competition on audit services market, (2) greater regulation of auditing and accounting, (3) increased litigation risks, (4) development of technology, and (5) greater complexity in the economic environment in general, with consequences for the capability of financial reporting and auditing to reflect economic reality. In such a reality, it seems that the structure and standardisation offer a kind of promise to produce more legitimate audits for the benefits of audit firms. The competition in the audit market creates the incentive for lowering the costs of audits through the standardisation of the audit process. Regulation and increased litigation risk are linked in the legitimisation processes in which regulations define the auditor's legal responsibilities and hence, potential failure to meet these responsibilities may lead to costly litigation for the audit firm. Structure, therefore is seen as lowering contingent audit costs from negligence. The complexity of data processing systems and of economic environment more generally, implies that audit tasks are growing more complex. Hence, audit firms promote the argument that structured audits and decision aids are there to help the auditor to 'better understand' the complexity of information. In structuring the audit process, audit firms impose restrictions on audit independent judgement (Francis, 1994). Structured methodologies and audit approaches (pre-established structured plans, checklists, etc.) are expressions of striving for standard services and objectivity. In result, structured audits are used whether appropriate or not. This may have a deteriorating effect on an operational independence, i.e. the auditor's capacity to freely decide scope and character of audit procedures and techniques (Power, 1997).

The rationale for structure rest on the technocratic belief that the audit is a technically solvable problem. There are a number of examples of the applied structure in audit practice. Firstly, the auditing standard SAS 300 (APB, 1995) intimates that the risk model is an abstraction whose usefulness lies as a tool for audit planning; it illustrates how a scientised representation of the audit masks the hermeneutical character of auditing practice. It does so by reducing the rich complexity and contingency of each unique audit and the diversity of audit testing strategies to a three parameter statistical model of audit risk. The audit risk model cannot tell the auditor what to do or how to do it in a meaningful way because it is contextless and therefore represents 'empty

abstraction' (Francis, 1994, p. 255); it creates an illusory reality. Audit judgement is subordinated to and debased by that reality.

Secondly, expert systems⁷ (knowledge based systems) are the expression of striving for structure and objectivity in audit decision making. These systems are believed to improve audit consistency by insuring appropriate audit procedures and reducing the likelihood of human error. While the development of such systems may be able to reduce costs and increase efficiency and effectiveness of audit in the short-term, there is a danger that necessary human development and expertise may be sacrificed if decisions and judgements routinely come within the domain of such systems. Many of the expert-system applications have been used in the areas of audit planning (Sirvastava et al., 1990), risk assessments (Graham et al., 1990), internal control (Francis, 1994), and selecting efficient combination of audit procedures (Broderick, 1988; O'Leary and Watkins, 1989). For example, Francis (1994) cited an example of operational decision aid in audit firms: the standardised internal control questionnaire, which in excess of six hundred questions forms a basis for evaluating internal control systems. The presumption of such decision aids is to include all possible contingencies. The auditor's objective becomes a matter of completing the questionnaire rather than understanding the internal control system. These developments indicate that technology is being applied to sophisticated areas of audit judgement.

Thirdly, the development of structured methodologies and more detailed standards is an evident expression of technocratic reality in audit practice. Dirsmith and McAllister (1982) promoted a contingency approach to audit, trying to reconcile the use of structured decision aids, such as pre-established plans, checklists etc., to a tailored approach in which each audit is viewed as unique. Under such an approach, the auditor needs to be able to determine when the circumstances warrant departure from the pre-established or structured plans. This understanding, however, is itself a hermeneutical moment which cannot be objectified and reduced to prestructured decision aids that tell the auditor when to switch the approach. The use of decision aids and expert systems in the audit process implies that the decision structures are imposed through a computer system. At first, the individual is not in the position to question or change that structure. Such process leads to non-reflective learning where the practical and theoretical validity claims are accepted as behavioural norms instead of being verified or mediated. (Dillard, and Bricker, 1992, p. 220). Technology becomes embedded in both the context of the task and in the psychology of the individual auditor. If the auditor solely engages in instrumental action, the normative and subjective dimensions of judgement are lost leading to distorted understandings and ultimately to distorted actions.

⁷ The goal of expert systems is to represent the decision making process in algorithmic form so that non-experts can qualitatively make the decisions as experts.

In summary, the argument in this study is that the independent judgement of the individual auditor, in particular independent in operational sense, is increasingly conforming to standardised audit procedures and in consequence to rule-bound reasoning through structure and method. These practices deteriorate understanding and hermeneutical dialogue proceeding from the auditor's own prejudices and an application of this understanding to specific contexts of the client milieu. These prejudices enable a dialogic process of interpreting and understanding the economic text of the financial statements. The consequences of individual judgements and actions are not necessarily reflected upon and mediated by the auditor, hence, judgement is not aware of itself.

'The auditors may lose the capacity for moral and critical reasoning and hence for moral agency with respect to their actions qua auditor' (Francis, 1994, p. 235).

Structure of the audit process displaces the auditor's subjectivity and individuality as a hermeneutic agent and puts into question the authority of tradition in auditing and the authority of the auditor to draw upon that tradition for doing the audit. Kinney (1986) argued that in the US, more highly structured audit firms favoured and lobbied for auditing standards in general, and especially those which imply or justify a standardisation in audit practice (e.g. statistical sampling). These standards came to be viewed as norms for practice which put further pressure on all auditors to adopt structured audit methodologies. Bowrin (1998) argued that the Big Five auditing firms all followed a similar methodological approach, which he defined as being semi-structured. It could be argued that such an approach potentially provides leeway for the auditor to transcend a structural orientation in his/her judgement.

Of course, judgement is always present in audit practice, even with structured (semi-structured) decision aids and audit approaches. Judgement and structure must be intertwined, but structure should be facilitative of subjective and independent thinking.

There are trends in the auditing milieu which create incentives for and advantages of more structured auditing. Further, the auditing practice as social practice is sustained and threatened by two kinds of institutions: (1) the audit firm, in which the auditor is employed, and (2) outside institutions such as the professional regulatory bodies, the legal system, and general political economy. For the audit firm to persist it needs to have some power over individual action inside it in order to increase the control of the environment outside⁸. The organisation (i.e. audit firm) in order to increase its legitimacy reflects the myths of its tradition and institutional environment; formal structure can be envisaged as such a myth (Meyer and Rowan, 1977, p. 341). According to

⁸ Organisational theory portrays organisations as 'cultures' which shape their members' behaviour and perceives the individual as being modelled by the logic imperatives of the organisational structure. Hence, the organisation has assumed capacity to confer identity on its members by identifying with that organisation (Cohen, 1994, p. 93).

Giddens' theory of structuration (1984) neither individuals nor system are the principle objects, but the social practices ordered across space and time where individual actions are marked by routines and habits. He sees structure, which patterns human activities, and the system, which is being reproduced.

'In order to be the auditor, you have to act as one' (Pentland, 1993, p. 608).

Displaying the appropriate behaviour and conformance to structure are essential to the creation of the professional in auditing. Professionalism is symbolised by the comportment of the auditor on the job, including his/her language and dress. Dressing well, carrying the right kind of briefcase, and 'looking the part' are the basics of the professional front (Pentland, 1993, p. 618). For the individual, the meaning of actions becomes embedded as routines in his/her general body of knowledge. Hence, widely defined structure is seen as

'[T]he properties which make it possible for discernibly similar social practices to exist across varying spans of time and space' (Giddens, 1984, p. 17).

Another aspect of structure implies the existence of institutions embedded in wider contexts; institutional rules which enact upon the reproduction of practice and institutions seem highly intertwined. Auditing practice entails a reciprocal and dialectical relationship between the auditor and praxis. The widely defined environment and profession, envisaged simultaneously as institution and tradition, play an important role in supplying meanings and values for the creation and maintenance of the auditing milieu. The auditor on the job is situated in the context of on-going interactions with other auditors, the audit firm, the client, and the profession. This emphasises the social and contextual aspects of the audit work. The perspective of the auditor's creative searching for understanding is essential to the identification of dynamics between the auditor and the construction of the meaning for audit evidence⁹. Hence, the auditing milieu consists of multiple overlapping and intersecting power of institutional networks and causal sequences which are 'too complex to be theorised' (Mann, 1986, p. 29). In effect, the level of auditor's subjectivity and individual judgement institutionally regulated are defined to serve the purpose of the regulator. The client's economic power seems to serve in reshaping the meaning of audit from a professional judgement for shareholders into a compliance statement for the regulator. Hatherly (1996) argued that audit quality should be build from within the audit process, and not imposed from outside through compliance regulation. Given the political attractiveness of the protection through compliance regulation where normative forces institutionalise judgement processes, it seems a difficult task. Hence, the processes of legitimation seem to displace

⁹ In particular, judgement process setting can be recognised as one of the major sources of referents, i.e. the symbolic meanings of the auditor's self-understanding.

legitimation through reference to individual judgement since already given technical knowledge is not mediated or deliberated by the auditor.

It could be argued that the organisational 'learning process' and the environment of the work place predispose the auditor's attitudes to audit tasks so as his/her style of conduct becomes enveloped in the routine of materiality concerns and risk assessment. As a result of 'compliance pressure' to maintain a high standard of practice the auditor does not reflect enough upon the methodologies of the audit approach. In effect, the auditor may not be fully aware of him/herself, in particular not aware of his/her capacity for authentic, independent reasoning. Hence, it seems that the structuration of the audit process has somewhat bypassed the genuine understanding of the auditor. This relates to the concept of 'fixation' of human action. Fixation facilitates a detachment of the meaning of action from the event of its performance (Ricoeur, 1981). This concept is evident in the audit judgement process, and can be depicted in its 'production' in accordance with the rules of the profession, which offer practical guidelines for 'performing' the audit. Alternatively, the fixation of judgement can be envisaged as something the auditor could have avoided doing as a result of his/her knowledge of predisposition. This results in the loss of the judgmental subjectivity by fragmentation of experience and loss of meaning for independent judgement.

As an effect of standardisation, understanding in auditing is reduced to the application of technique. The audit firms increasingly rely upon procedural arrangements (e.g. operating manuals, working papers) to maintain the quality of audit service. Dirsmith and Mcallister (1982) argued that structured and standardised audits deprofessionalise auditing practice and lead to bureaucratic controls over individual auditors. Auditing is permeated by legal risk which enters the audit process as liability exposure and this creates a certain mode of conducting and representing the audit process in working papers as a discourse in a defensible manner (Power, 1997, p. 139). The audit working papers become discursive representations of the auditor's discernment and judgement. But more importantly, the working papers are all that is visible and that can be examined by quality reviewer (or peer reviewer). Working papers document the work done during the audit and support the conclusions; nearly everything that the auditor does on the job involves creating or using these documents. Further, the practice of reviewing the auditor's work is an obvious structured mechanism of control. Reviewing has a sound basis in rational principles of error avoidance and correction. The review notes enforce the details of audit mechanics (Pentland, 1993, p. 614). The audit firm thus must document and produce artifact, the trace of the audit, for the outside (and the peer review); this is a potential force for promoting highly structured 'legitimation' in audit practice. The working routines of the auditor are an important way to symbolise and establish legitimacy. Legal risk leads also to representations of the scope and capability of audit in official documents in order to maximise its discretion. Since legal processes question rarely the body of knowledge, only the enactment of it, defensibility is less a matter for

the individual auditor, but it involves mostly the development of procedural knowledge, conformity to which counts as *best practice*.

Francis (1994) argued that auditing practice is shifting away from a grounding in the auditor doing auditing (i.e. producing audit), towards the production instead of working papers, what might be termed a discourse about the audit; Francis (1994) calls it after Baudrillard (1983) a pure simulacrum.

'The audit becomes a pure simulacrum, an institutionally driven discourse about auditing that is its own reality. Audits become centred solely on the production of working papers for the purpose (reality) of producing working papers...There no longer is an audit, only a discourse about an audit' (Francis, 1994, p. 261).

In that sense, the auditor's role is instrumentally defined by this discourse of audit, which is to be produced to construct and document the working papers. The 'realm of the real' becomes only that what is reproduced. As institutional practice auditing

'[T]ends to be self-perpetuating regardless of relevance to or achievement of goals. This disjunction between means and goals is enlarged by scarcity of resources, ambiguity of services, status anxiety of agents, cultural emphasis on efficiency and effectiveness, and on exclusive possession of skills' (Sieber, 1981, p. 208).

Auditing tradition however, is where subjectivity and being in the world for the individual begins, where the capacity for understanding and critical reasoning begins, where the professional constructs realities, their interpretations and ways of construing the world beyond the norm system of reality (Ahrne, 1990, p. 6). Organisational culture reposes in the professional who brings it to the organisation. That is, individuals, rather than organisations, are the agents of culture; their agency is constituted by their experience of self (Giddens, 1991, p. 53). Hence, audit culture is not rigid, it is rather readable and interpretable, and continuously remade through individual behaviour. Practice envisaged in such a way constitutes something more than mere efficiency. There is something 'intrinsic', an insight, as a result of professional judgement and interpretation interacting with the contextual factors in socially constructed hermeneutic practice.

4.7 Summary

In short, in this chapter it was argued that by taking a hermeneutic turn, audit practice can be envisaged as an interpretive enterprise in terms of meanings that *auditors create judgement (action) and share structure (text)*. Ricoeur's version of hermeneutics, in particular his analogue between social practice and written text from which the existence of structures emerges, evokes the need for an explanation of unarticulated conditions which encompass audit praxis. In the audit

process, the underlying meaning of evidence becomes detached from individual performance, therefore objectified and appropriate for an open act of interpretation. Awareness of processes and structures represents the perceived 'contextuality' of the audit. The practice-structure relationship is encompassed in the roots for action; that is in individual inclinations, attitudes and desires. It was argued that the objective conditions of the audit firm are integrated with subjective understandings, and so simultaneously enable and constrain an individual audit endeavour. The auditor on the job strives to understand client's operations and to interpret the 'economic text' narrated in the financial statements. By doing so, he/she produces assurance to the public that these interpretations are trustworthy.

This chapter also indicates the possibility of the debasement of critical reasoning by structure-judgement tensions. The profession and the audit firm propagate a symbol for the *ideal of service*. This can be illustrated by conformity to routines of operational approaches objectified by the abstraction embodied in the professional standards and guidance. The argument for structure advantage centres on two themes; of economic efficiency and litigation protection. Since judgement varies between individuals, it may be idiosyncratic and sometimes inaccurate. Some structure is therefore necessary to guide the individual. On the other hand, unstructure is facilitative of subjective thinking. More structure mediates judgement and reallocates it in a way that the auditor does not reflect upon the format of the audit process, and characteristics of the task. The auditor's interpretive power is constrained by explicit frameworks and compliance practice. As a result, working papers as a means of symbolic legitimisation processes become discursive representations of the auditor's discernment. The profession needs to redefine ways of understanding the audit to enable individual capacity for critical and independent reasoning about the client's 'economic reality'. Since authentic action in audit seems to be processed from the auditor's good understanding, which emerges through interpretive practice (Francis, 1994), audit quality may be built from within the audit process (Hatherly, 1996) and not be imposed from outside through regulation. Hence, standardisation processes of the auditing milieu needs to develop in ways so as to somewhat transcend the 'downside' effects. Auditing envisaged as a hermeneutic practice is one of such alternative ways. For instance, the return to a more traditional function of auditing, involving the auditor in an exercise of expert judgement and in the role of judge, would suggest expanding an institutional domain for audit individual judgement, beyond a mere verification.

'Nothing takes the place of judgement: the laws of probability are only a guide'
(Prytherch, 1942, cited in Power, 1997, p. 74).

Drawing on the tradition of judgement, a value of the auditing profession, the auditor is depicted as an interpretive agent, and his/her interpretive power should be at the heart of the discipline.

This study is enveloped in a duality of hermeneutics aimed to portray dynamics between the auditor and 'readings' of evidence as economic text. These dynamics are embedded in context of interrelation between anticipated components of audit judgement milieu and research findings. Chapter 7 is devoted to the analysis of auditors' narratives in order to create an open story about the 'realm of the real' in audit practice. The auditors are both the actors and authors of that story.

CHAPTER 5

Research design and research methods

5.1 Introduction

The study seeks to obtain supportable insights from questionnaire data and interviews as to the impact of the client's power and the structure of the audit process on individual judgement. The research is designed to examine whether the auditor is capable of transcending the structure of the audit process and thus applying wide horizon judgements beyond risk and materiality concerns when the audit environment is 'shadowed' by NAS opportunism. Hence, the experimental design reflects two different tensions. First, between the auditor's independent judgement and the structure of the audit approach: a 'wide horizon' tension (i.e. associated with an operational independence threat). This is embedded within a second tension between the provision of NAS and fraud recognition: a 'narrow horizon' tension (i.e. associated with an apparent independence threat).

This research brings together three highly topical audit issues in a single research experiment. The experiment explores how the individual auditor's sensitivity (1) to the possibility of fraud, (2) to the client's management representations and (3) to management service opportunities (NAS) impacts upon audit judgement with respect to the likelihood of error and the need for detailed checking of controls and transactions. In particular, the auditor's willingness to 'buy into' the client's management representations is examined as one of the auditor's potential weaknesses in cases where non-audit services opportunity arises. The client's management may manipulate their explanations in a way so to deflect the auditor from consideration of the problem as a possible cover for fraud. This may be done, for instance, by presenting a weak internal control system as an immediate or potential opportunity for the audit firm to provide a management service. In such circumstances, the auditor should still be able to analyse potential threats arising from fraud clues and from weaknesses in the client's control structure as a part of their diagnostic understanding of the client's business, its systems and controls. This is complemented by the qualitative analysis of personality and attitudinal factors which influence the orientation of the auditor in the context and affect the extent to which penetrative insights in judgement processes are made.

This chapter commences with an examination of relevant qualitative and quantitative methodologies. Following that, the research objectives are briefly discussed in the light research methodologies deployed (Moser and Kalton, 1979). The combination of qualitative and quantitative methods, the chosen approach for this study, is then explored. This is followed by a discussion of the development, refinement and inner logic of the research design. Next, the selection of the respective population and the development and administration of the requisite research instruments are presented. Data collection involved a two-stage process; firstly a case-study survey was carried out based on mail questionnaires, following that interviews including a process tracing exercise and semi-structured questions were conducted. The subsequent section discusses the research population, response rate and demographic characteristics of respondents. Next, a discussion of narrative analysis perceived as a vehicle for exploration of interview data is presented. This is followed by a discussion of statistical tests used to analyse questionnaire data. These include the Chi-test, Spearman rank-ordered correlation coefficient, and Kruskal-Wallis one way analysis of variance. Finally limitations of the study are discussed.

5.2 The qualitative and quantitative methodological mix

Qualitative and quantitative methods constitute alternative strategies for research (Patton, 1990). The term qualitative covers a range of approaches. Van Maanen (1985, p. 9) sees it as an umbrella term covering an array of interpretative techniques which seek to describe, decode, translate and otherwise come to terms with the meaning, not the frequency, of a certain social world's phenomena. Patton (1990, p. 24) argued that qualitative measures are longer, variable non-systematic and more detailed in content. Thus, data which results from such qualitative measures is rich and renowned for its depth. Quantitative measures, on the other hand, are easily aggregated for an analysis. They rely on the use of instruments which provide a standardised framework in order to limit the data collection process to certain responses and/or analysis categories (Patton, 1990, p. 14). The resulting information provides a somewhat static account of social life (Bryman, 1988, p. 140), and an account of the regularities and patterns of existing structure.

The auditor's awareness of, and sensitivity to the possibility of fraud, to the client's management representations and to non-audit services opportunities as well as the level of professional scepticism applied in a structured audit are built into the research design. There are a number of methods, based on the previous studies discussed in chapters 2, 3 and 4, that might be applied to investigate the effects of selected issues on independent audit judgement and recognition of fraud.

They include both qualitative and quantitative methods, such as mail questionnaire surveys, interviews, case studies-based experiments, etc. Different methods used in these previous studies indicate that both qualitative and quantitative techniques can be used in audit judgement and decision making studies (although much prior research on audit judgement and decision making primarily focused on quantitative methods). Each method has its own strengths and weaknesses, and no single method is likely to be fully comprehensive and sufficient in itself.

It has been argued that qualitative studies allow a greater richness and depth in the analysis of the data, but are more subjective. On the other hand, whilst precision and accuracy are conveyed in statistical data generated by quantitative research studies, the construction of questionnaires and/or case studies to produce raw data on which the statistical calculations are based, is open to subjectivity bias in the same way as asking questions at an interview. Hence, a major trade-off between qualitative and quantitative methods is a trade-off between the breadth and depth of the study (Patton, 1990, p. 165). Breadth is facilitated by the quantitative approach, in that it allows measuring the reactions of many subjects but at a cost to depth because the range of criteria must be limited. Qualitative methods generate a wealth of detailed information from a much smaller number of subjects and often produce a surplus of knowledge.

An important strategy to strengthen the study design is through triangulation; the combination of research methodologies in the study of the same phenomena (Jick, 1985, p. 136). Hence, rather than seeking qualitative and quantitative methods as being competitive, they are seen as complementary. Qualitative work assists quantitative work by providing a theoretical framework and interpreting statistical results (Fielding, 1993; Fielding and Fielding, 1986).

‘Triangulation captures in a more complete, holistic, and contextual manner the unit(s) under study and may be used not only to examine the same phenomenon from multiple perspectives but also to enrich our understanding by allowing new or deeper dimensions to emerge’
(Jick, 1985, p. 138).

It has been argued that the effectiveness of triangulation rests on the premise that the weaknesses of each single method will be compensated by the counterbalancing strengths of the other (Jick, 1985). Triangulation increases confidence that research findings can lead to each approach enriching and validating the other and may be better imparted to the audience (Faulkner, 1982, p. 87).

This study embraces a qualitative and quantitative methodological mix that captures aspects of the phenomenon under investigation in a more complete and holistic manner. Research is experimental, based on mail questionnaires and interviews. The mail questionnaires provide breadth to the study, by examining approaches to judgement of a bigger sample of respondents. Interviews provide rich detail to the study and allow probing further into the more ambiguous aspects of judgement, which remained uncovered by the statistical analysis.

A diagnostic task (based on the case study of the questionnaire) is carried out by subject audit seniors and audit managers using both between and within subject design. The experiment design embodies a routine structure of audit practice; a planning memorandum alongside the tasks of risk and materiality assessments. That is, the experiment is designed to trigger a certain structure within the audit judgement process, a presupposed repeated pattern of a conventional audit approach. The evidence derived from mailed questionnaires data is based mostly on non-parametric analysis and is further explored and validated through follow up interviews. Interviews are carried out to gain more insight into the audit judgement processes, and the auditor's personal characteristics and are aimed to establish how the auditor perceives the environment of the audit firm with respect to the emphasis placed on fraud discovery and/or the development of management services. The interviews and the audit process-tracing data (verbal protocol) are intended to describe the details of audit judgement processes and to contribute to understanding of the more ambiguous aspects of the audit judgement environment on both empirical and theoretical grounds.

The use of a combination of methods should provide the most useful insight into audit judgement processes, enabling reasonable coverage to be achieved (the mail questionnaire) whilst at the same time allowing some deeper understanding to be obtained (interviews and process-tracing exercise).

5.3 Research design

The experiment (a diagnostic task of the questionnaire's case study) focuses on a poorly managed control system. A weak control system is permissive of fraud and error, and it may also represent a potential management services opportunity in terms of systems design and advice (i.e. NAS). The auditor's confidence in the client's management may be shaken by the discovery of a poor system but this can be restored significantly where the client's management represent that they have responded to the problems clearly and positively. In general, the auditor's scepticism

moderates the level of confidence in the client's management representations, and accordingly influences the auditor's judgement with regard to a need for detailed checking of controls and transactions. The individual judgement varies across auditors depending upon the auditor's experience, especially of the client, and the auditor's personal traits. This study examines the impact of these factors on the auditor's individual ability to recognise the manipulations in the client's management 'selling offer' as a cover for possible fraud when the work environment 'promotes' a structured audit approach. The question is whether the auditor perceives a compliance dilemma between the concepts of audit independence and integrity (defined in the Auditor's Code of Ethics) and the internal policies within a cultural context of the audit firm in which he/she works under such circumstances.

The research instrument imposes an ad hoc structure on audit judgement, which is typical of 'risk based' auditing¹. The process of devising the research instrument was facilitated by the advice provided by an anonymous Technical Partner from one of the Big Five auditing firms. As a result, the instrument contains the semi-structured approach to audit, similar to those used in the Big Five (Bowrin, 1998) (prior to the recent introduction of new audit methodologies). A standard audit format facilitates the examination of judgmental processes embodied in individual discourses of the audit planning memorandum. Hence, the experiment presents a scenario conducive to the application of a standardised approach in the audit process alongside the structure of risk and materiality assessments. A two-year span of the study is introduced to examine anchorage (i.e. a dominant theme in the auditors' narratives) in the planning memorandum when the problem appears durable across cases.

The instrument is comprised of three case studies (A, B, C) based on a diagnostic task with different arrays of fraud clues and NAS opportunities. These cases allow for different emphases in judgmental reasoning (i.e. the across-cases design secures differentiation of the case's circumstances). The subjects were asked to complete the questionnaires comprising a concise case study, split into a year 1 scenario and a year 2 scenario; each followed by series of questions.

5.3.1 Case study for the first year

The core of the scenario incorporates a real situation, which was taken from one of the recent Big Five audit firms' fraud cases. The audit firm wins by tender a new client with a good general

¹ The subjects were familiar with new audit methodologies for 'strategic' auditing at the period the research was conducted. However, these methodologies weren't operational at that time. Further, regardless of the different methodologies used, some structure is inevitably present in the audit process.

reputation - a small listed company which assembles and installs laboratory equipment across Europe. For the purposes of the tender, the client has been assessed as a low engagement risk. On the initial planning visit the auditor learns that there have been problems with one of the key accounting systems - with the sales record-keeping system. An old computerised system for sales is unable to deal with new types of sales contracts. The auditor is advised that the recent problems have arisen when inexperienced staff had conducted the manual preparation of invoices and journals and that errors had resulted. The basic setting, therefore, is a newly discovered weak control. In addition, there is a possibility of fraud - a slight red flag - regarding European Union grants, which are available to customers of the audited company on the purchase of the research equipment. Subjects are divided into three groups (A, B, C) with each group receiving different information regarding the managerial response to the weaknesses in the sales record-keeping system. At one level, the managerial response is common across all three groups. In each case, the client's management represents that a major internal exercise has been launched to identify and correct errors and that suitable staffing is being allocated to the sales record keeping. In the cases for groups B and C, however, the client's management believes there is also a need for a more fundamental solution and they intend to develop and implement a new sales invoicing and recording system. Subjects in group B are advised that their audit firm will be invited to tender for the work, whereas in group C they are informed that the contract has already been signed with outside consultants (not connected with the audit firm). Thus, the three groups are faced with three different managerial responses from the client embodying three different opportunities to promote management services, as presented in Table 5.1.

Having been given details of the case (A, B, C) subjects are invited to make an interpretation of K plc and on that basis to list the main points in a memorandum for audit planning purposes. Subsequently, subjects are invited to assess the likelihood of material misstatement, and the need for further audit work as being indicative of the audit judgement they would make.

The literature, as reviewed in chapters 2 and 3, is divided as to whether the existence of an NAS opportunity influences audit judgement. The concern is that a desire to secure the management service contract will discourage the audit firm from upsetting the client's management. Hence, the auditor will not wish to appear to challenge the client's management when they represent that the problem has been fixed. As a consequence, the auditor will be disinclined to extend the detailed checking or at least to charge the client as a response to the sales system problems. This issue is examined through a comparison of the subjects' judgements in case B versus case C.

Table 5.1
Case Study for Year 1

GROUP	Management Response	Management Service Opportunity
A	Internal exercise launched. Management represents that (1) errors are corrected and (2) suitable staffing is allocated to the sales record keeping to avoid further errors	Management needs persuading. (Potential)
B	As with A, but states intention to design and implement a new sales system.	Audit firm invited to tender. (A good opportunity)
C	As with B, except faster off the mark since the contract for the new sales system has already been awarded.	Contract awarded to outside consultants. (Opportunity lost)

Given the speed of management’s response, confidence in the client’s management might, *prima facie*, be marginally higher in case C. If case C subjects require a tougher audit than case B, therefore, the implication is that B subjects have been compromised by the existence of NAS opportunity. The issue can also be examined through a study of case A subjects’ responses. *Prima facie*, given a low key response, confidence in the client’s management for case A might be lower than for B or C. Thus, more extensive audit work might be required than for the B or C cases, but the question is whether the status of case A as a ‘potential’ NAS opportunity changes the outcome *vis a vis* C. Alternatively, case A audit work may be less rigorous than case B or C. If so, it could be that unlike in either B or C, the client’s management in case A do not regard the sales system’s patch as a temporary solution and are therefore more likely to give both the internal exercise and testing of the patched sales system more attention.

5.3.2 Case study for the second year

The case study (A, B, C) is extended to the second year of the audit, it having been assumed in all three cases that the audit work carried out in year 1 enabled the audit firm to issue an unqualified opinion. A further year's experience allows the auditor to update their assessment of the client's management, and in the experiment, the second year is designed to explore the auditor's reaction to different fraud signals associated with different levels of confidence in the client's management.

At one level the second year's experience is the same for all three cases. In each case it is found that the change to more appropriate staff has not solved the problem and errors have continued to occur. In each case therefore, the client's management once again represent that they have launched a successful exercise to identify and correct all the errors. In case A the client's management respond to the continuation of the sales system problems by undertaking to issue a contract for the design and implementation of a new sales system. The audit firm will be invited to tender. Case A, year 2 (A2) is therefore, very similar to B1 except that the client's management in A2 may have lost some credibility through their delaying of a more fundamental response to the existing problem. Cases B2 and C2 are similar to each other in that neither B nor C have yet implemented the new sales system. In B2, subjects are advised that the audit firm won the design and implementation contract. They are further advised that the audit firm's consultants have serious doubts about the client's management's specifications of the new sales system. In particular, they are concerned that the client's management is insistent upon the sales system incorporating unusual features, which, according to the consultants, would allow the client's management to backdate accounting entries with respect to sales without trace. This is intended to raise a serious fraud signal. In C2 the auditors are unable to establish the precise reasons for the delay in an implementation. The client's management claim that the consultants have not delivered to specification, whilst the consultants claim the work is complete and the delay is down to the client's management. This is intended to raise the 'possibility' of a fraud flag, being management's delay in the system's implementation. Thus, in the second year the three groups are faced with three different experiences of the client's management each associated with a different level of suspicion regarding management fraud, as presented in Table 5.2.

Table 5.2
Case Study for Year 2

GROUP	Experience of Management Fraud	Suspicion of Management (Fraud Signals)
A	Management belatedly recognise the seriousness of the problem and state intention to place contract for new sales system. The audit firm will be invited to tender.	Slight fraud flag, not significantly greater than case B1
B	The audit firm won the tender but the new sales system is not yet implemented. The firm's consultants are concerned by management's insistence that 'unusual features' are included in the new sales system.	Serious fraud flag
C	The new sales system is not yet implemented. There is a dispute between the client's management and the consultants as to the reasons.	Moderate fraud flag

Again in year 2, having been given details of the case, subjects are invited to interpret the K plc client and on that basis to list the main points in a memorandum for audit planning purposes. Subsequently, subjects are invited to assess the likelihood of material misstatement and the need for further audit work as indicative of the audit judgement they would make.

The inclusion of a second year allows one to adopt both a between subjects and a within subjects design in the research. In the between subjects design the study looks for statistical differences between the three groups attributable to the different experiences of the client's management contained in the three cases embedded in a structured audit approach. In the within subjects design the study looks for statistical differences between the same group in years 1 and 2 attributable to that group's additional experience of the client's management in year 2.

For the between subjects design it is hypothesised that the ordering in respect of the rigour of audit work based on the level of suspicion of management fraud is $B2 > C2 > A2$. If $B2 > C2$, then it might be argued that in the second year the audit firm's involvement in consultancy has benefited the audit through knowledge spillovers which are not available in case C2. This is a point which is sometimes made in the literature in a defence of management service provisions by audit firms since it may potentially enhance the audit firm's knowledge of the client's business and its management. See chapter 2 for the literature review on the provision of NAS and effects of knowledge spillovers.

As regards the within subjects design for case A the question is whether confidence in the client's management in case A2 is reduced by the continuing failure of the existing sales system, or enhanced by management's belated recognition of the need for a new sales system. In cases B and C, however, it can be hypothesised that the rigour of the audit work should be greater for B2 than B1 and for C2 than C1 given the suspicion of management fraud present for both these cases in the second year. Thus, the experiment examines the issue raised in the auditing literature as to whether auditors recognise and respond to fraud flags (chapter 2 presented a literature review on fraud).

In short, the experimental design reflects two different tensions: first, between the auditor's independent judgement and the structure of the audit approach: a 'wide horizon' tension (i.e. operational independence threat). This is embedded within a second tension between the provision of NAS and fraud recognition: a 'narrow horizon' tension (i.e. apparent independence threat). Chapters 2 and 3 presented a discussion on the concept of audit independence and audit judgement.

5.4 Collection of data: Questionnaires and interviews

The collection of data was based on two stages. First, a mail questionnaire survey was carried out. The second stage involved interviews including a process tracing exercise. Before launching the questionnaire, its draft version was piloted with the members of the Institute of Chartered Accountants of Scotland (ICAS) and with the members of Accounting and Business Method Department at the University of Edinburgh. The aim of the piloted study was to identify problems associated with construction of the questionnaire and to ensure that the narrative part of case studies and associated questions were relevant and clear. Constructive comments on the drafted

version allowed refinement of the questionnaire; changes were made to the layout of some questions and some additional information to the narrative part of the case study regarding the financial performance of K plc and an initial assessment of the client as a low engagement risk client was included. The final version of the questionnaire is included as Appendix 1.

5.4.1 Mail questionnaires

The final version of the questionnaires, together with a covering letter and stamped addressed envelope were mailed to 185 individuals. The design and the layout of questions are of importance to the achievement of a high response rate. Berdie et al. (1986) argued that the appearance of the questionnaire frequently determines whether it is read because once the respondent takes an effort to read it, he/she made some commitment to complete it. The final version of the questionnaire, in particular the narrative part of case study, was interesting, short and easy to read and complete. Further, the confidentiality and anonymity of responses were clearly pointed out in both the questionnaire and the covering letter.

The questionnaire consists of three short sections A, B, C. Section A asked for a demographic profile of the auditor. The purpose of this section was to obtain background information on the respondents and included standard questions on length and nature of their work experience, their age and gender. Section A included five questions. Question 1 asked for the age of the respondent. Question 2 asked for gender. Questions 3 and 4 asked for the experience in the audit firm including its length (in years) and the current position in the firm.

Sections B and C include a concise case study, split into a year 1 scenario followed by short series of questions (the questions from 6 to 10) and a year 2 scenario followed by short series of questions (the questions from 11 to 15).

The subjects were asked to complete the questionnaires comprising the concise case study, split into year 1 and year 2 scenarios (sections B and C). The core of the scenario incorporates a real construct, taken from one of the Big Five audit firms' cases. Section 5.3 presents details of the research design.

In both years, having been given details of the case, subjects made an interpretation of K plc and on that basis composed a list of the main points in a memorandum for audit planning purposes (question 6 in year 1 scenario and question 11 in year 2 scenario). The strategy for data

compression and interpretation was based on the method of a reduction to the core narrative (Bell, 1988), this represents the case of NAS and material misstatements embedded in structure of 'risk-based' auditing (a narrow horizon of the study).

'How we arrange and rearrange the [experiment] text in light of our discoveries is a process of testing, clarifying and deepening our understanding of what is happening in the discourse' (Mishler 1991, p. 277).

The auditors' discourse made in the audit memorandum embodies their subjective interpretation of the overall situation of K plc. The recurring words in the respondents' narratives led to insights that shaped its sub-categories; such process determined the classification of the responses in the audit memorandum. The boundaries of this classification are shaped by the scope of this study – the case of material misstatements and NAS opportunism enveloped in the structured audit. There is an explicit reliance on underlying theoretical concepts embedded in the experiment itself, such as NAS opportunism (Mitchell et al. 1993), fraud recognition (APB, 1995) and anticipated tensions between the structure of the audit process and individual judgement (Hopwood, 1998; Power, 1997).

Three independent categories of auditors' discourse emerged. Firstly, if conventional terms such as risk, materiality, compliance with auditing standards were dominant themes in the memorandum, the subject was categorised under 'conventional audit practice'. This category represents a narrower scope for the interpretation of K plc. Secondly, if the dominant theme of the memorandum was associated with questions over the client's management integrity and/or potential intentional misstatements, the subject falls under 'potential fraud recognition'. Thirdly, if the points concerning the opportunities for NAS were incorporated in the memorandum, the subject was categorised under 'recognition of NAS'. Categories two and three indicate a broader scope to the interpretation of K plc, beyond standard audit practice of 'risk-based' auditing.

Both the construct and order of memorandum narratives is bound to the auditors' judgements upon K plc's context. These individual judgements may 'become normalised by being accepted as the conventional template for action' (Llewellyn, 1999, p. 229). Hence, these narratives reveal to some extent conditions for possible organisational strategies for audit judgement within the audit firm. All categories are summarised in Table 5.3.

Table 5.3
Classification of auditors' discourse in the audit planing memorandum

Conventional audit practice 1	Potential fraud recognition 2	Recognition of NAS 3
High risk/overall High risk/debtors High risk/sales (I) Materiality considerations Detailed tests to perform Standard audit practice (II) K plc financial performance (III) Knowledge of error sought (IV) Systematic error carried over (year 2 memo) Risk controlled in year 1 (year 2 memo)	Management integrity Intentional misstatements 'Back-date' entries concern Dispute with consultants concern Problems with new system implementation	New system sought System under design Offer a review or/and assistance on the system

(I) system inadequacy, manual invoicing, management competence (with regard to sales system)

(II) plc, compliance, accuracy, comparatives, new client, quick audit, Greenbury and Cadbury, overseas SSAP20, grants SSAP4, VAT investigations, going concern

(III) Concerns over business activity, capital, profit, sales, production process, profile of customers/suppliers

(IV) Extent and persistence of error

In addition to the composition of the audit memorandum, the auditors were required to assess the level of risk of K's plc financial statements containing a material misstatement (questions 7 and 12) and to estimate a budget of hours for the testing of the sales cycle (questions 8-9 and 13-14)².

In this study, a degree of conformity with the routine of the audit process for risk and audit testing assessments determines the structure consistency of judgement. The potential changes from year 1 to year 2 made with regard to the level of risk and/or the extent of audit testing were applied in one of the following directions: (1) an increase, (2) a decrease, and (3) no change in the level of risk and/or of the budget for testing. Hence, possible situations for judgement consistency include: (1) same (SS), (2) higher (HH) and (3) lower level of risk *and* lower budget in year 2

² The risk embedded in the cases is theoretical; it does not really affect the audit firm. In this type of research there is always a question whether the instrument properly asserts subjects' approach to audit. Hence, it has to be addressed as a limitation of this study.

(LL). Hence, possible situations signifying judgement inconsistency include: (1) higher risk and same budget for testing i.e. (HS), (2) higher risk and lower budget for testing (HL), (3) same risk and lower budget for testing (SL), (4) same risk and higher budget for testing (SH), (5) lower risk and same budget for testing (LS), and (6) lower risk and higher budget for testing (LH).

5.4.2 Interviews

The second stage of the data gathering process involved interviews. All interviewees were guaranteed confidentiality at the outset of the fieldwork and promised that they would not be individually identified in the research. This was done in order to elicit open and unguarded responses to the questions asked during the course of interviews. At the beginning of each interview and before embarking on the collection of data sought, the purpose of the study was briefly outlined and the importance of interviewees' opinions was stressed. In addition, each interviewee was offered an option to receive a brief report of the findings when the study is completed.

The first part of the interviews was devoted to a process tracing exercise. Garfinkel (1967) demonstrated that individual performance is embedded in and inseparable from a body of common sense knowledge and practical reasoning which renders conduct 'accountable'. The process tracing exercise recognises that talk is the primary vehicle for the accomplishment of social actions. The production and intelligibility of performance are the self-same resources through which sense of the particular action (audit) is assembled. These resources of common sense knowledge and of practical reasoning are 'seen but unnoticed' and thus unavailable to unguided intuition, introspection or theoretical imagination. Garfinkel (1967) and Sacks (1992) demonstrated that these resources are made accessible through detailed analysis of performance. Thus, the analysis of a verbal protocol exercise focuses on the situated organisation of individual performance and derives from activities from within the situation in which it is produced and rendered intelligible. Individual judgement is contextual and situated. The accomplishment of judgement, its sense, impact and accountability are embedded within the particular situation (audit). Social actions rely upon a body of common sense knowledge and reasoning. This method is particularly relevant both in the production and in the recognition of situationally embedded ordinary conduct (audit practice).

Protocol analysis facilitates the verbalisation of judgement and decision making behaviour, and is particularly suited to developing an understanding of how individual judgement and decisions are

made (Bouwman et al., 1987). Decision behaviours can not be improved without understanding the nature of processes underlying behaviour (Hogarth, 1991). The verbal protocols are a common technique in auditing research (Trotman, 1997). Recent judgement and decision making research has emphasised an interplay between subjects' characteristics and tasks (Johnson, 1983). The strength of judgement process tracing is its ability to provide generative explanations of *in situ* conduct and gain insights to the sequential unfolding of organisational performance of the audit firm. These explanations, however, do not rely on extraneously formulated analyses or theoretical models of action.

In this study, the subjects were invited to 'think aloud' while performing tasks, notably the construction of the narrative form of the audit memorandum for planning purposes. These narratives allowed the researcher to see how the auditor understands and responds to the structure of the audit process and how some auditors are capable of transcending their experience of the structure of 'risk-based' auditing. Responses represented auditors' treatment of auditing standards and their response to the structure of the audit task.

The judgement process tracing exercise allowed a check for the correctness of the classification of the auditors' discourse made in the audit planning memorandum (questions 6 and 11 in the questionnaires). Here are examples of the auditors' narratives made in the audit memorandum and subsequent extracts from the process tracing exercise.

'Background to company – to set scene. Sales problems. Detailed review of the discussion the client showing value of an error, actions taken by the company, possible impact on the accounts, impact on our testing' (Russell, Senior Auditor, Audit memorandum in year 1, case A).

The process tracing exercise served to enrich Russell's answers in the memorandum for year 1 of the audit.

'It is obviously the first time we are being involved with the client, so we do not have a great deal of information about how the client operates. We have got the overview, the client is generally low risk. We then find out that the client has problems with sales, and it is 10% of total sales. If I were to write the audit memorandum, I would like to put some background about the client to allow the reader to find out more about the client, and then since we know there is a problem, I would focus in the memo on the sales problems, trying to work out the possible value of error and what testing we would do for that. If all of the 10 % was error, then I thought there was not high chance of

material misstatements there...Turnover, profit and stuff like that – I wasn't overly interested in them. But I was interested in the fact that it was 10 % of sales. I thought it was most relevant thing, because if it would be 2.5 % the chances of material misstatements would be very slim, if it would be 25 % the chances of misstatements would be lot more...so I thought this figure was most relevant. 10 % of sales would be £ 20m. If it is restricted to 10 %, it is not over worrying. I think that there is quite low profit for the high sales figure...On the whole, there was enough information to work out the type of the client...i.e. turnover and profit figures. It allowed me to estimate the size of the company. It was good to mention it was low engagement risk. It was well explained how errors arose. I was able to think about the impact and consequences of it. It was also good to mention the problem as 10 % of sales. It allowed me to work out how much time I would have to have' (Russell, process tracing in year 1, case A).

Russell's concerns were associated with issues of materiality and background information to the client since he mentioned a few times 'a problem of 10% of sales'. In year 2, similarly to year 1 he focused his concerns on materiality of error (clearly not even on misstatements).

'Sales errors – highlight basis of the problem, highlight the value. Highlight that same error as last year and last year's corrections by the company as well as our work and an opinion issued' (Russell, Audit memorandum in year 2, case A).

Subsequently the following information was extracted from the process tracing exercise in year 2.

'In the second year the problem happened again. I would be able now to talk about the results of prior year testing. I thought that it would be slightly less risk of error. I think that the client would have learned something through going through the same process in the prior year, and probably correct things better. We are still looking at 10 % of sales income. I was also trying to look at the bright side here – even though they did not manage to correct errors by the year end, but hopefully they still have good knowledge and the ability to correct it this year. From the audit point of view it seems slightly lower risk, depending on the outcome of last year, but I thought it was not too bad at all... for the company to have material errors two years in the row' (Russell, process tracing in year 2, case A).

Issues beyond a conventional audit approach were not present in Russell's reasoning. He clearly focused on materiality issues. Hence, Russell was classified under category 1 'conventional audit practice' in both years of audit (C1>C2).

An example of 'big-pictured' reasoning is illustrated by the audit memorandums of Stephan (case B). Stephan, early in year 1 of the audit, enlarged the scope of judgement beyond materiality and risk concerns.

'Can we rely on the old system? Need a computer specialist. How do they ensure that all invoices passed and that none are double-counted? How do they track trade debtors on invoices input by journal? Do they appear on the sales ledger? Will need to review the resolution of the issues regarding mis-postings. Alert computer specialists about possibility of a tender for new system' (Stephan, Senior Auditor, Audit memorandum in year 1, case B).

A process tracing exercise resulted in more insight into Stephan's memorandum.

'The first thing I have picked up was sales system difficulties. They have an existing computer system, but there are some sales that are done manually. That is obviously a risk, because it is something different from the normal system. Again you have inadequately experienced staff, and I wondered what sort of risk it would indicate. They said that they have suitable staffing. And then the problem represents 10 % of total sales, so it is material for this kind of company. Other systems are working satisfactorily – good. And then can we rely on old systems since it is a new client? They have a computerised system producing accounting information – can we rely on it? Does the trial balance add up for example? Does it produce reports that can be relied upon? I would advise our consultants to look at the system and assess the reliability of it. There is a problem with manual invoices, human error comes into it. How do we know that they are posting all the invoices? We have to check for that. Then thinking in terms of how do they manage their business, if they have a computer system that has a debtors' ledger so they can probably track those who paid and those who haven't paid. How do they deal with manual invoices? There is input by journal entry. So how they are going to track payments, and collections of debts. Do they appear in the sales ledger or is it just one big figure, i.e. £1m of manual invoices. Mis-postings....have they sorted out mis-postings problems? How they are going about to sort all those problems and whether we are happy with the ways they have done that. Last point there is the comment that...if they are going to introduce this new sales system, and I suggested that our computer specialist do some work there – if the specialist does not know that we will be tendering in the future, then we should let him/her know that, so he/she can bear it in mind' (Stephan, process tracing in year 1, case B).

In year 1 Stephan focused on risks associated with the sales system and on the opportunity for management service (IT consulting). Hence he was classified under the category of 'NAS

focused' in year 1 (NAS1). In the following year he 'switched' his attention from non-audit services opportunities to fraud concerns.

'Reliability of management. Why do they only correct at the year end? Why do they want to backdate entries without trace? (Stephan, Audit memorandum in year 2, case B).

The process tracing exercises confirmed Stephan's primary concern with fraud.

'In year one we issued an unqualified audit report – that is good. We won the tender to design a new system – which is good. There are still the same problems. It is disappointing. But they were able to solve the problems last year – through an internal exercise. Hmm...I would be concerned that errors are still occurring. We would recommend to them that this is not good enough – why they are still happening and they did not sort them out. There is a risk here that there will be errors occurring. And a last comment...why do they want to backdate the entry without trace. It does not sound very good. The way that we approach audit work is that we rely a lot on key controls that management has in place. Somebody looks at management accounts and identifies if there are any funny looking figures...Here the information couldn't be relied upon, as there are controls breakdowns. We would have to change the audit approach in this particular area. And the fact they are talking about backdating entries without trace...I think it becomes riskier. We would maybe need to look at other areas too. We need to find out what management is up to regarding backdating entries. My overall perception was that this client is a bit dodgy – not only on the basis of the figures, but on the basis of the control environment and the client's culture in general (Stephan, process tracing in year 2, case B).

Since in year 2 Stephan's primary concern was with managerial fraud. He was classified in year 2 under the category of 'fraud recogniser' (F2).

Not all of the auditors' performance could have been categorised as either a conventional (Russell's example) or a 'big-pictured' mode (Stephan's example) across a two-year span. Some auditors switched their judgement orientation from a conventional mode in year 1 of treatment to a 'big-pictured' mode in the second year. Therefore, it was necessary to consider two categories of switchers between conventional and 'big-pictured' modes, i.e. those conventional auditors who switched to fraud recognition (C1>F2) and those who switched to an awareness of NAS (C1>NAS2) in the second year of treatment. These two examples of the auditors-'switchers' are illustrated by the audit memorandums of Sarah (case C) who switched from a conventional mode

to fraud recognition in the second year of treatment, and Andrew (case A) who switched from a conventional mode to NAS recognition in the second year of treatment.

Sarah in year 1 applied a conventional approach to audit. It was only in year 2 when she enlarged the scope of her judgement.

'Inadequacy of sales ledger processing manual invoicing, journal entries made manually. Variety of sales terms increasing potential for error in addition to processing error. A need to look at the client's systems' (Sarah, Audit Manger, Audit memorandum in year 1, case C).

A process tracing exercise in year 1 confirmed conventional concerns in Sarah's judgements over K plc in year 1 of the audit.

'I think obviously it is a new client and we have been through the proposal process and we have found out a reasonable amount about the client – it is a listed client. It has advantages and disadvantages. Advantages that you would expect to work with the previous auditor. Disadvantages that you may have to do it more rigorously, because of the public and information to be believed. We have got reasonable financial statements... We have a change of system, which is always a period of risk and uncertainty. And we change procedures and processes at the same time. So you have a lack of familiarity with the system but also with procedures underlying the system. The other thing is that invoices processed manually aren't significant with regard to total sales. Ok, they are not that significant in value, but are they disproportionate with regard to the number of invoices in it... It looks like reasonable performance, 5 % of profit margin is not high, but is not too low either' (Sarah, process tracing in year 1, case C).

In year 1 Sarah was classified under 'conventional audit practice' category (C1). The second year brought a change in Sarah's judgements, enlarging her 'picture'.

'All as per year 1. Relationships with outside consultants...i.e. dispute. Continued inadequacy with sales system' (Sarah, Audit memorandum in year 2, case C).

Insights from process tracing confirmed Sarah's 'big-picture' judgement in year 2 of the audit.

'So the first year audit went reasonably well. Interesting here is the dispute with consultants – we have to understand that – because it could be a contingent liability under way. In terms of how much more involvement we got in that, I think you have to consider very carefully. It doesn't say

in any way that the consultants make any claim against to get management, so management claim against outsiders. What are the costs and how much of management time it is taken to deal with this and not being directed to the business. I think you want to know why the manual operations happened to be amended to prevent the errors to happen again, that shows the lack of management control, once unacceptable and twice a bit careless. I would want to make sure that information is really available before committing to audit...We need to understand the relationship with the consultants, we do not know whether there is a continuing relationship or what other arrangements K plc made to continue service' (Sarah, process tracing in year 2, case C).

In year 2 of the audit, besides concerns with the risk of material error Sarah questioned management integrity and was concerned with the dispute between management and consultants. Hence, she was categorised under 'fraud recognition' (F2).

Similarly, Andrew applied a conventional approach to the audit in the first year of treatment. It was only in the second year when his judgement's orientation has enlarged.

'We [the audit team] had not, as yet, performed any testing on this or any other system. Thus, there is a need to address this and other related risks, e.g. debtors. A need to ensure that errors have stopped and an extent of error needs to be highlighted (its potential impact)' (Andrew, Senior Auditor, Audit memorandum in year 1, case A).

The process tracing exercise in year 1 confirmed conventional concerns in Andrew's judgements over the client K plc in year 1 of the audit.

'Firstly, there is a large potential impact – a problem arising from the manual sales – 10 % of the sales value. I suppose, more profit than the capital employed would have an impact on how we would calculate materiality, because the capital employed is fairly large. It is something we [a team] would have to understand fully. The problem could expand on the whole sales processing systems, in which case, we have to consider whether or not to involve with the client. Sales are obviously debtors related, so we would need to look at debtors...also at the other areas such as VAT areas. The client thinks that the system is being corrected and is controlled manually...this may need a closer examination...To understand how the problem arose and what it is related to, there is something you could do to deal with it in an efficient manner; and that is, in many cases like this you would actually review the client rather than perform a great scale exercise. You would get the client to justify its position in detail. You would have to understand the position of

the company, things such as its trading performance and a general background to the business. I would say there is a reasonably high risk there' (Andrew, process tracing in year 1, case A).

In year 1, Andrew was classified under 'conventional audit practice' category (C1). The second year of treatment brought a change in Andrew's judgmental mode and he switched to see a 'bigger picture', i.e. the NAS opportunity.

'The errors of the same nature as highlighted in the year 1 memorandum. The client had performed an exercise to ensure that the errors were tested, which we tested and found no material errors. A new system is being sought' (Andrew, Audit memorandum in year 2, case A).

Insights from process tracing confirmed Andrew's 'big-picture' judgement orientation in year 2 of the audit.

'Firstly, I would look at how things apply to a prior year audit, it is just to show really that we have some background knowledge and an understanding of the nature of the problem, its extent, how did it arise, how it was dealt with. Now, the client is looking at the replacement of the system, so typically if it is a client which has a significant problem - in one of the areas fairly important - we would push the client to resolve it and we could assist to solve the system problem. We can go to the process of testing and make sure that the position is corrected. We would end up with testing the elements or the final position.' (Andrew, process tracing in year 2, case A).

In year 2 of the audit, besides being concerned with the persistence of error, Andrew was aware of the need for a new system design and suggested the audit firm's assistance in this respect. Hence, he switched to a 'NAS recognition' category.

The following four categories of judgmental mode emerged; that is, a conventional mode (i.e. $C1 > C2$), a 'big-pictured'-versatile mode (i.e. $NAS1 > F2$) and two switching to 'big picture' modes (i.e. $C1 > F2$ and $C1 > NAS2$). Hence, the above four examples of the individual narratives reveal to some extent the ways in which judgement strategies are promoted in the audit firms (organisational strategies). Although the task 'to think aloud' is somewhat an abstraction of real performance 'on the job' (Anderson and Potter, 1998), the verbal protocol allows one to get some insight into understanding of attitudes towards and structure of tasks associated with construction of the memorandum at the planning stage of the audit process. The process tracing exercise confirmed the categorisation of the auditors' responses in the audit planning memorandum.

The second part of the interviews was based on questions regarding auditors' attitudes to structure and judgement and their personal traits. A semi-structured approach was chosen.

'The semi-structured interview is a process in which the interviewer focuses his/her attention on some limited number of points. He/she may range quite widely around a point, but it would be done only as means of getting the required information on the particular point'
(Smith, 1972, p. 119).

Hence, as this study was concerned with a number of issues; that is, it recognises the influence of the characteristics of the audit process, the power of the client and personal traits of the auditor on behavioural and ethical reasoning in audit judgement processes, this approach (semi-structured) was more appropriate than either unstructured or structured interview approaches. The unstructured interview was inappropriate because it assumes that questions and/or topics emerge from the immediate context and are not at all determined in advance (Patton, 1990). The structured interview approach was inappropriate because it did not allow for the spontaneity of responses (Fontana and Frey, 1994). Hence, a free style allowed the researcher to alter the sequence of questions and to probe for more information. The questions were mostly open-ended in order to gain spontaneous insights with regard to the auditors' attitudes and actions. They were embedded in symbolic interactionism perspective where the context of production of data, intrinsic in its understanding, somewhat allowed the respondents to use their own particular way of defining the world. This part of the interviews was intended to identify the relevant dimensions of auditors' motivations in their judgements at the planning stage of the audit process, in particular with respect to the recognition of potential fraud, and their attitudes to the structure of that process. Since structure in audit firms is based mostly on rules and systems that reside in several levels of human and social consciousness, it was important to allow for some spontaneity in responses.

These interviews lasted about an hour each and were tape recorded and transcribed, providing a source of longer verbatim quotations. Recording of data was important in order to increase the accuracy of data collection and to allow the researcher to be more attentive to the interviewee and to assure that the interactive nature of the interview was not interfered with³ (Patton, 1990).

³ However, one of the problems associated with the use of tape recorders is that it may somewhat interfere with the openness and depth of a discussion (Patton, 1990).

The use of narratives is common in ethnographic research, and less in auditing research (Pentland, 1993, p. 608). It provides data associated with the more ambiguous aspects of audit judgement and decision making, in particular it depicts to some extent the interplay of the application of standards, structure of audit task and the auditor's behaviour in judgement processes.

In short, the readings of data were themselves located in process tracing and individual discourses. This combined method resulted in detailed insights into some aspects of audit judgement at the planning stage of the audit process.

5.5 Research population

The random sample of audit seniors and audit managers was drawn from the Big Five auditing firms. The target group for this study consisted of audit seniors and audit managers in order to match the requirements of the task embedded in the case study questionnaire with suitable experience of the respondents. Tasks similar to the one included in the case study are normally performed by audit staff at senior level; that is, with at least 2 or 3 years of audit experience. The selection of the Big Five's offices was made in a way that maximised the geographical spread within the UK. A list of the Big Five audit firms' offices were obtained from the ICAS official directory (ICAS, 1997). In some cases, colleagues in the Department of Accounting and Business Method at the University of Edinburgh and connections with the auditing profession provided contact names for each office. These persons were then contacted and asked to provide a list of audit seniors and audit managers of that office. Most offices agreed to participate in the study. These offices furnished short lists of names of their audit seniors and audit managers. Then questionnaires were sent to those individuals.

Out of 185 mailed questionnaires launched in autumn 1998, 74 usable responses were received (i.e. a response rate of 40 %). This response rate resulted from the initial mailing in autumn 1998 and follow-up telephone calls made in December 1998. Some auditors requested follow-up mailing of the questionnaire. The questionnaire response was very satisfactory. It was much higher than can normally be expected in a mail questionnaire survey. Many respondents (i.e. 68%) requested a summary of the results. A summary of the questionnaires' responses is presented in Table 5.4.

Table 5.4
Timing of responses

	Number of responses	Response rate %*
First mailing	59	31.8
Follow up telephone call	11	8.7
Second mailing	4	2.3
Overall responses	74	
Overall response rate	40 %	

* Response rate by reference to the residual proportion, e.g. second mailing $(4/185-11)=2.3\%$.

A non-return bias is impossible to check since the study guaranteed the anonymity of respondents⁴. The high response rate suggests, however, that non-response bias is unlikely to be a problem.

At the second stage of the study, interviews were carried out. Information regarding the possibility to participate in follow-up interviews was included in the mail questionnaires. The subjects were asked to provide names and addresses at the end of the questionnaire if they expressed an interest in participation in an interview. Ten individuals were selected for interviews. These individuals were chosen from two Big Five audit firms based in Edinburgh: PriceWaterhouseCoopers (5 subjects: 4 male and 1 female) and Arthur Andersen⁵ (5 subjects: 4 male and 1 female). The selection was made to reflect diverse attitudes to judgements and the auditors' different backgrounds and experience. Interviewees represented both senior and managerial levels in the audit firm (5 audit seniors and 5 audit managers). All 10 subjects agreed to participate.

⁴ The impossibility of check for non-return bias must be addressed as an unavoidable weakness of this study.

⁵ According to Kinney's categorisation (1986) the Big Five audit firms were structured in different ways: Delloite & Touche and KPMG were perceived as structured, PriceWaterhouseCoopers as unstructured, and Arthur Andersen and Ernst & Young as semi-structured. Kinney's categorisation (1986), however, did not include recent mergers among the Big- Five auditing firms, e.g. PriceWaterhouseCoopers. Further, Bowrin (1998) argued that the Big Five all followed similar semi-structured audit approach.

5.6 Narrative analysis

The statistical analysis of questionnaire data is taken further into an interpretive dimension. The narrative turn takes the study beyond its traditional focus on the representation of organisational structures of audit process and the client's power to encompass knowledge of agency. The narrative is a form of a meta-story as it depicts the interview quotes from a central perspective (i.e. the soul of narrative) embedding them in the underlying theoretical stance. The story metaphor emphasises that we create order, and construct texts bound to particular contexts (Reissman, 1993, p. 1). These contexts encompass an analysis of individual experience of the auditor and an analysis of the structures which make this experience possible.

'Culture speaks itself through individual stories...It is because of their subjectivity, their rootedness in time, place, tradition and personal experience that we value them'
(Reissman, 1993, p. 5).

There is a growing interest in developing narrative methodologies in accounting research (e.g. Llewellyn, 1999; Boland and Schultze, 1996; Sinclair, 1995). Llewellyn (1999) examined how narratives can be understood and used as forms of explanation and argument in accounting research in general. Boland and Schultze (1996) presented how narratives can be used in the production of individual accountability (acceptable self). Sinclair (1995) used narratives of chief executives in the public sector to illustrate different forms and discourses of accountability.

In this study, narratives identify some conditions of the possibility of action within an organisation (the audit firm), and show how its objectives can be normalised by being accepted as the 'conventional template' for action (audit), hence absorbed into taken for granted assumptions of organisational reality and/or organisational strategies (i.e. structuration processes). The portrayal of these conditions and consequences is inherently political as it draws on interpretations of both auditors and the author, interpretations reflecting on individual experiences and identities (Llewellyn, 1999, pp. 221 and 228-229).

Since this study focuses on the organisations (the audit firms) and more specifically on the auditors employed in these firms, the language of these individuals becomes an important part of the analysis. The methodology most suitable for this purpose is thus hermeneutics since it can be used for the analysis of human action (audit). Chapter 4 was devoted to a discussion on the theory

of hermeneutics. The goal of hermeneutics is to give an understanding of a phenomenon (audit judgement) through the interpretations of actions and statements in the context of the phenomenon (audit judgement milieu). The conditions that need to be met in order to achieve an understanding of human action include a common language, a common tradition (in the field), self-understanding, all of these encompassed in a theory of interpretations. A common language with the subjects of study is necessary to interpret individual behaviour and statements. For instance, professional jargon in auditing may somewhat disable understanding. A common tradition refers to a personal knowledge of the field of auditing enabling one to place actions and statements in an appropriate context. Self-understanding refers to the ability to understand oneself. If one is able to understand self well, he/she is capable of understanding others (in a similar cultural background since those individuals are assumed to act according to similar norms or rules). As the result of interviews whole passages of text need to be taken apart in order to discover the underlying rules or systems of rules presented in them. To do so, an interpretation theory is necessary, which in this study is embedded in a hermeneutic methodology.

Based upon the assumption that society is socially constructed, interpretations concur when similar interpretations can be made from statements presented from different individuals. Thus, research is based on an interpretation of an interpretation. The first interpretation is made by subjects of the culture in question (the auditing practitioner), and the second by the author as he/she interprets the actions and statements of the subject auditors. Giddens (1974) referred to this phenomenon as the duality of hermeneutics. In addition, if similar interpretations can be made from the statements of several subjects, the reliability of these interpretations increases.

The present study is enveloped in the duality of hermeneutics. First, the auditor in the study is envisaged as acting in 'hermeneutic way'. That is an interpretive interrelation between audit evidence and the auditor is assumed where the auditor 'reads' the economic text of the audit evidence applying subjective judgements. Second, research is embedded in hermeneutic methodology where research findings are somewhat anticipated by the pre-understandings of the audit judgement milieu.

5.7 Statistical analysis

The research design which was determined by the micro-structure of independent judgement and embedded in the case of NAS provisions' opportunities and fraud recognition, allowed for a certain pattern of the auditors' behaviour to emerge. As a result, two categories of the auditors

with different judgmental orientations were identified: (1) a conventional mode (i.e. $C1 > C2$) and (2) a 'big-picture' mode sub-divided between a 'big-pictured'-versatile mode (i.e. $NAS1 > F2$), and a 'big-pictured'-switched to fraud recognition mode (i.e. $C1 > F2$) or to NAS opportunism mode (i.e. $C1 > NAS2$). The conventional group responds very strongly to the structure of the audit process and being compliant with a layout of the materiality and risk assessments is unable to enlarge the judgmental scope of the client's environment. The sub-group of the 'big-pictured'-versatile auditors transcends the structure of 'risk-based' auditing and sees beyond the traditional format of the risk and materiality issues, i.e. sees further particulars in the client's milieu. The two sub-groups of the auditors-switchers enlarge their judgement orientation (to fraud recognition or NAS recognition), but only in the second year of treatment, after having some experience and knowledge of the client. The statistical analysis was used to ascertain whether these different groups of auditors perform differently. Chapter 6 demonstrates statistically significant differences in consistencies in the auditors' judgmental performance.

In this study, statistical analysis is based on non-parametric tests and seeks to obtain supportable and useful insights from the questionnaire data as to the impact of the structure of audit process on individual audit judgement, in particular with regard to the recognition of potential fraud and/or NAS opportunity.

Non-parametric tests are uniquely suited to the data of the behavioural studies (here of judgement and decision making). They are based on a model that specifies only very general conditions and none regarding the specific form of distribution from which the sample was drawn such as for example a normally distributed population⁶. These tests may be applied appropriately to data measured in nominal, categorical or ordinal scales (in ranks and/or in seemingly numerical scores with the strength of ranks). An important advantage of non-parametric tests is their usefulness with small samples. In addition their interpretations are often more direct than the interpretations of parametric tests⁷ (Siegel and Castellan, 1989, pp. 34-36).

⁶ Certain assumptions are associated with most non-parametric tests, namely that the observations are independent, sometimes that the variables under study have underlying continuity, but these assumptions are fewer and weaker than those associated with parametric tests (Siegel and Castellan, 1989, p. 3).

⁷ An objection to non-parametric statistics is that they are not systematic in comparison with parametric tests. However, examination of these tests reveals common themes – the tests for categorical data are systematic and many of the tests applied to ordered data. The differences are on the surface, i.e. the formulas sometimes obscure the underlying relations between tests (Siegel and Castellan, 1989, p. 36).

In the present study, the following non-parametric statistics were used to examine the impact of the structure of audit process and NAS opportunism on individual audit judgement, in particular with regard to the recognition of potential fraud and/or potential management services: (1) Chi-test for independence of samples for nominal scale data, (2) Spearman rank-order correlation coefficient as a measure of association for ordered data, and (3) Kruskal-Wallis one way analysis of variance for independent samples for ordinal scale data.

5.7.1 Chi-test

In the examination of differences between groups, the question of whether these groups are independent or related must be determined. The usual parametric technique for analysing data from two independent samples is to apply a T test to the means of the two groups. T test assumes that the scores (means) in the samples are independent observations from normally distributed populations with usually equal variances. When the data consist of frequencies in discrete categories, the Chi-square test may be used to determine the significance of differences between two independent groups. The hypothesis being tested is that two groups differ with respect to some characteristics, and, therefore, with respect to the relative frequency with which group members fall in several categories. The focus of the Chi-test is on whether the differences in proportions (observed) exceed those expected as chance or random deviations from proportionality (Cochran, 1952).

The Chi-test is applicable if the expected frequencies are sufficient in size, i.e. 5 and more for a sample size of between 20 and 40. When the Chi-test is used there is usually no clear alternative and thus, the exact power of this test is difficult to determine (Siegel and Castellan, 1989, p. 124).

This study is concerned with the auditor's ability to recognise potential fraud or NAS opportunity reflecting tensions between independent judgement and the structure of the audit task. Whether the auditor can not see beyond a conventional audit approach (the group of conventional auditors) or is capable of spotting a fraud flag and/or NAS opportunity in the K plc's case by interpreting the material over a broader scope (the group of 'big-pictured' auditors). Thus, the null and alternative hypotheses were tested: These hypotheses are as follows:

H0: The auditors adopt a standard (conventional) approach to audit across cases irrespective of the client's situation.

H1: There are differences in the approach to audit among the auditors across cases.

These hypotheses were tested by examining the conventionality of the audit approach across cases; that is, the actual proportion of 'big-pictured' and conventional auditors. Chi-test checked for the independence of samples of 'big-pictured' and conventional auditors across the pairs of cases.

Further, a degree of conformity with the routine of 'risk-based' auditing (same direction applied with regard to estimations of risk and hours for audit testing from year 1 to year 2 of treatment) determines the structure consistency of judgement. A conformity with the structure of the audit task were examined across the four different groups of auditors previously identified ($C1 > C2$, $NAS1 > F2$, $C1 > F2$ and $C1 > NAS2$) by the following hypotheses:

H0: There are no differences in consistency with regard to estimations of risk and hours for audit testing from year 1 to year 2 of treatment among auditors ('big-pictured'-early NAS recognisers ($NAS1 > F2$), late NAS recognisers ($C1 > NAS2$), fraud recognisers ($C1 > F2$), and conventional auditors ($C1 > C2$)).

H1: There are differences in consistency with regard to estimations of risk and hours for audit testing from year 1 to year 2 of treatment among auditors ('big-pictured'-early NAS recognisers ($NAS1 > F2$), late NAS recognisers ($C1 > NAS2$), fraud recognisers ($C1 > F2$), and conventional auditors ($C1 > C2$)).

These hypotheses were tested by examining the actual differences in structure consistency of 'risk-based' auditing; that is differences in directions with regard to estimation of risk and hours for audit testing from year 1 to year 2 of treatment among the auditors. Chi-test checked for independence of samples of those who were consistent with the structure and those inconsistent with the structure across the pairs of the auditors ('big-pictured'-early NAS recognisers ($NAS1 > F2$), late NAS recognisers ($C1 > NAS2$), fraud recognisers ($C1 > F2$), and conventional auditors ($C1 > C2$)).

5.7.2 Spearman rank –order correlation coefficient R_s

In the judgement and decision making literature whether two sets of scores are related, and if so what is the degree of their relation, is often sought (i.e. establishing a correlation). In the

parametric case, the usual measure of correlation is the Pearson product-moment correlation coefficient. This statistic measures the degree to which there is a linear functional relation between variables. If the data is ranked (based on ranks), the Spearman rank-order correlation coefficient may apply (i.e. simplifying formula for the Pearson statistic when the data comprises of ranks). It is a measure of association between two variables which requires that both variables are measured in at least an ordinal scale so that the objects or individuals under study may be ranked in two ordered series (Chatfield, 1988). Occasionally some subjects receive the same score on the same variable. When tied scores occur, each of them is assigned the average of the ranks (Siegel and Castellan, 1989, pp. 235-237).

Using MINITAB the correlations were sought between the level of risk and number of hours prescribed for audit testing. Because the subjects of the study were drawn randomly from the population of the audit managers and audit seniors, ranked scores may be used to determine consistency with regard to the assessment of audit risk (risk consistency). The question is whether the judgements regarding the level of risk and number of hours assigned for audit testing are associated (in year 1 and in year 2 of treatment). Thus, the following hypotheses may be tested in year 1:

H0: Judgements regarding the level of risk and number of hours for audit testing are not positively correlated among the auditors in year 1 of treatment (the groups of auditors include 'big-pictured'-early NAS recognisers ($NAS1 > F2$), late NAS recognisers ($C1 > NAS2$), fraud recognisers ($C1 > F2$), and conventional auditors ($C1 > C2$)).

H1: There is a positive correlation between these judgements among the auditors in year 1 of treatment ('big pictured'-early NAS recognisers ($NAS1 > F2$), late NAS recognisers ($C1 > NAS2$), fraud recognisers ($C1 > F2$), and conventional auditors ($C1 > C2$)).

In the second year these hypotheses were restated:

H0: Judgements regarding the level of risk and number of hours for audit testing are not positively correlated among the auditors in year 2 of treatment (the groups of auditors include 'big-pictured'-early NAS recognisers ($NAS1 > F2$), late NAS recognisers ($C1 > NAS2$), fraud recognisers ($C1 > F2$), and conventional auditors ($C1 > C2$)).

H1: There is a positive correlation between these judgements among the auditors in year 2 of treatment ('big pictured'-early NAS recognisers ($NAS1 > F2$), late NAS recognisers ($C1 > NAS2$), fraud recognisers ($C1 > F2$), and conventional auditors ($C1 > C2$)).

The Spearman rank-order test examines correlations between the level of risk and the number of audit hours assessed in year 1 and year 2 of treatment between groups of recognisers of NAS opportunity or/and of potential fraud and conventional auditors.

Further, structure consistency with regard to risk (i.e. between the level of risk and the number of audit hours assessed in year 2 of treatment) can be checked across the three cases (A, B, C). Hence, the following hypotheses with regard to risk consistency (association between judgements regarding the level of risk and number of hours assigned for audit testing) across cases are tested for year 1 of treatment:

H0: Judgements regarding the level of risk and number of hours for audit testing are not positively correlated among the auditors across cases in year of treatment.

H1: There is a positive correlation between these judgements among the auditors across cases in year 1 of treatment.

In the second year these hypotheses were restated:

H0: Judgements regarding the level of risk and number of hours for audit testing are not positively correlated among the auditors across cases in year 2 of treatment.

H1: There is a positive correlation between these judgements among the auditors across cases in year 2 of treatment.

When sample sizes are larger, that is about 20 to 25, the significance of the Spearman rank-ordered correlations is approximately normally distributed with mean 0 and standard deviation 1.

The efficiency of the Spearman rank-ordered correlation coefficient when compared with the Pearson statistic is about 91% (Siegel and Castellan, 1989, p. 244).

5.7.3 Kruskal-Wallis test: Risk assessment across the groups

ANOVA is a general technique for partitioning the overall variability in a set of observations into components due to specified influences and to random error (Chatfield, 1988). The ANOVA technique was introduced to the audit literature by Ashton (1974). The model measures the significance and percentage of variance accounted for by main effects and interactions. ANOVA designs have been used in audit judgement studies concerning internal controls evaluation and audit planning (Ashton, 1974; Mock and Turner, 1981), materiality (Messier, 1983), evaluation of internal auditing (Abdel-khalik et al., 1983), uncertainty disclosures decisions (Libby, 1979), inherent risk (Colbert, 1988), and analytical review judgements (Brown and Solomon, 1991).

One way analysis of variance (ANOVA) between the groups of non-recognisers (conventional auditors), fraud recognisers and the NAS focused, allows closer examination of the risk assessments in both periods of treatment between the three groups (A, B, C). Any differences attributable to the different exposures in respect of the client's management response embody a different management service opportunity. Thus, the experiment is designed to assess both awareness of, and sensitivity to, those factors which are addressed in the experiment. A significant main effect across treatments implies that the auditor's judgements (i.e. median performance of risk assessment) varied systematically with changes in the particular cue⁸.

Kruskal – Wallis (hereafter KW) is a non-parametric version of one-way analysis of variance by ranks allowing testing for independence among the samples in the entire population. (Siegel and Castellan, 1989, p. 206-207). The null hypothesis is that the groups of non-recognisers (conventional auditors), fraud recognisers, and NAS focused come from the same population with the same median of risk assessment. The alternative hypothesis implies that the groups of auditors differ in the median performance with regard to risk assessments.

⁸ The percentage of variance accounted for by both individual cues and interactions of various cues can be measured by the omega squared statistic. The individual omega squared can be interpreted as being analogous to the squared product moment correlation in that it measures the percentage of variation explained. The sum of the omega squared is interpreted in a similar manner to linear predictability (R squared) (Trotman, 1997).

Thus, in year 1 of treatment the following hypotheses were formulated:

H0: There is no difference in the median of risk assessments between the group of conventional auditors (C1), fraud recognisers (F1) and NAS focused (NAS1) in year 1 of treatment.

H1: These groups of auditors differ in the median with regard to risk assessments in year 1 of treatment.

In year 2 of the treatment the following null and alternative hypotheses were formulated:

H0: There is no difference in the median of risk assessments between the groups of conventional auditors (C2), fraud recognisers (F2), and NAS focused (NAS2) in year 2 of treatment.

H1: These groups of auditors differ in the median performance with regard to risk assessments in year 2 of treatment.

When the obtained value of KW is significant, it indicates that at least one of the groups is different, but it does not tell which one. If H0 is rejected, the method of multiple comparisons may be used to determine which differences are significant.

The Kruskal-Wallis test has asymptotic efficiency of 95.5 %. This test is more efficient than the extension of the median test because it utilises more of the information in the observations, converting the scores into ranks rather than simply dichotomising them as above or below the median (Siegel and Castellan, 1989, p. 215).

5.8 Limitations of the study

The limitations of the study are related, in particular, to subject variation, partiality of interpretations and specificity of context, all of which affect external validity.

Firstly, the partiality of representations is related to subject selection and variation. It is important to recognise that there is subject variation in the responses based upon subjects' personal traits (in particular related to attitudes to judgement and structure metaphors and to learning styles) and their experience of situations similar to the scenario reflected in the case study's construct. The number of subjects allocated to the controlled groups (here A, B, C) needs to be sufficient in

order to ensure that the mix of personal traits and experiences in each group are representative of the population of auditors as a whole (Trotman, 1997). Senior auditors and audit managers drawn from the Big Five audit firms in the UK represented the selection of the group of auditors in this study. Such a selection was made in order to match the requirement of the task embedded in the case study with suitable experience of respondents. The audit staff at senior level (with at least 2/3 years of audit experience) normally perform tasks similar to the one included in the case study. Hence, the results of the study cannot be generalised beyond these two groups of senior auditors and audit managers. The findings need to be limited to those two populations. In addition, the sample of auditors was not entirely random. In some cases, reliance was placed on the individual audit firms to supply a complete list of the appropriate persons.

Secondly, the partiality of representations relates to the partiality of interpretations. At this point it is important to emphasise the partiality of interpretations of the auditors' narratives in both stages of the research. The research design, whilst articulating general principles of audit practice, was conceived through the unique engagement of the author with the individual auditors and particular material cases and hence inevitably resulted in a specific frame of reference and enclosure of text. Similar limitations are present in the particularity of the interpretative work of those subjects involved in the experiment.

Thirdly, the unique construct of this study, i.e. the case of audit judgement within the structured audit format, predetermines the context and boundaries of the research and hence defines the extent to which findings can be generalised in different settings. Although the research is designed on the basis of a real-life construct, the risk embedded in the case study is theoretical; that is, it does not have a real impact on the audit firm. In this type of the research design, there is always the question whether the instrument properly captures subjects' approach to audit. Hence, it has to be addressed as a limitation of research design. In addition, other elements of the audit milieu, not captured by the statistical sampling 'shadow' the auditors' assessments of risk and subsequently the estimation of audit hours in the case study.

Derived meanings from the auditors' story seem fluid and contextual, not fixed and universal. Hence, the world of text represents reality, i.e. the realm of the real in audit practice, selectively. Given the premise of an interpretive approach, the understanding of human practice through reflection on the synthesis of anticipated frames of references could only be partial. Consequently, the findings in the form of narratives construct a 'meaningful totality from

scattered events' (Ricoeur, 1981), not being constituted by a succession of episodes. Hence, the meaning of the text needs to be constructed as a whole whilst possessing an inherent plurivocality that allows it to be constructed and interpreted in multiple ways. It is the ontological conditions of the individual experience that fuels narrative construct. Thus, these narrative forms shared auditors' temporal belonging in the audit judgement milieu (the conditions of 'being in time') expressing the dynamics of individual audit practice both cognitively, and relating to intuition.

5.9 Summary

This chapter discussed the stages involved in the design and administration of the research. First, a brief discussion on qualitative and quantitative approaches was presented. As both approaches have their strengths and weaknesses, a combination of methods was used in this study. The concept of triangulation was explored, in particular with regard to the development, refinement, and administration of research methods. The implemented research strategy was twofold. Firstly, a case study experiment based on mail questionnaires was conducted. This method allowed capturing a phenomenon under investigation on a larger scale. Secondly, the interviews were conducted, in semi-structured format, in order not to direct the discourse of respondents. Interviews allowed the enrichment of the questionnaire findings. Further, the process tracing exercise confirmed and validated the correctness of auditors' categorisation (auditors' responses in the audit planning memorandum).

The study involved the use of a population of audit seniors and audit managers from the Big Five auditing firms based in the UK. The response rate (i.e. 40 %) was very satisfactory.

In short, the collection of research data employed a combination of mail questionnaires and interviews. This increased the likelihood that the picture emerging from this research represents a reasonable cross-section of insights into judgement strategies and opinions held by senior auditors and audit managers as to independent audit judgement and the structure of the audit process, as well as to the recognition of fraud and/or NAS opportunities. Four different patterns of the audit judgement processes emerged, consistent with there being different behavioural performance; that is (1) a conventional mode, (2) a 'big-picture' mode sub-divided between a 'big-pictured'-versatile mode and 'big-pictured'-switcher to fraud recognition mode or to NAS opportunism mode. Chapter 6 reports on the statistical analysis and ascertains whether the proportion of these different groups of auditors varies across cases and whether these groups deploy different levels of judgement consistency with regard to the structure of the audit task.

CHAPTER 6

Research findings: Experimental results

6.1 Introduction

The results from mail questionnaires, a copy of which is presented in Appendix 1, are explored in this chapter. The results were analysed using Excel and MINITAB. The research sample comprised of 185 individuals and included audit seniors and audit managers from the Big Five auditing firms based in the UK, as outlined in chapter 5. This chapter presents the profile of the respondents and provides insights into their judgement processes associated with recognition of material misstatements and their decisions with regard to the need for audit testing; that is, risk assessments and estimations of a budget of audit hours for testing. It reports on the general approaches held by respondents in relation to independence of their judgements, whilst the audit environment is obfuscated by NAS opportunism and a 'risk-based' audit approach is promoted.

The main part of this chapter reports on the effects of client's management representations, NAS opportunism and the structured audit on independent audit judgement and decision making at the planing stage of the audit process. The remainder of this chapter is organised as follows. Firstly, the profile of respondents is presented. The following section analyses the auditors' scope in judgement processes within the structured audit approach. Next, the anchorage of the auditors' concerns is presented. Finally, the incidence of auditors' consistency with regard to the structure of 'risk based' auditing is discussed. Two aspects of the incidence of auditors' consistency are examined. Firstly, consistency with regard to the direction of risk and the audit testing applied in year 1 and year 2 of treatment across the groups identified by the incidence of anchorage of individual judgements. Secondly, consistency with regard to values of the assessed risk across the groups identified by the incidence of anchorage and across the cases.

6.2 Profile of respondents

Fully completed questionnaires were received from 74 individuals (a response rate of 40 %). Demographic characteristics which relate to questionnaires' respondents are presented in Tables 6.1 and 6.2.

The majority of respondents were young, 44.6 % of the subjects falls into age group between 31-35 years whilst only 8.2 % of the subjects were 40 years old and over. 62 % of respondents held senior positions and almost 38 % of respondents held managerial positions in the audit firms they worked for. Only 15 subjects were female (20.3 % of the population) implying that the auditing profession is still male-dominated (Table 6.1).

Table 6.1
Questionnaires' respondents: Demographic characteristics

<i>Demographics</i>	<i>Number of responses</i>	<i>Response rate % of overall responses</i>
Position in the firm		
Audit Senior	46	62.2
Audit Manger	28	37.8
Overall	74	100
Gender		
Male	59	79.7
Female	15	20.3
Overall	74	100
Age		
>30	17	22.9
31-35	33	44.6
36-40	18	24.3
40+	6	8.2
Overall	74	100

Table 6.2
Questionnaires' respondents: Work experience

<i>Work experience</i>	<i>Number of responses</i>	<i>Response rate % of overall responses</i>
Length of audit experience		
Up to 3 years	25	33.8
4-5 years	26	35.1
6-7 years	15	20.3
8+ years	8	10.8
Overall	74	100
Career plans		
Remain in audit dep. Within the firm	37	50
Move to another dep. Within the firm	13	17.5
Move to industry or commerce	17	22.9
Other*	2	2.9
Not sure	5	6.7
Overall	74	100

* The category 'Other' represents those individuals who consider to change entirely their career.

Table 6.2 presents respondents' work experience and demonstrates that the majority (69 %) of respondents had between 3 and 5 years of experience in audit. For the purpose of this study, the experience requirement for all participants was a minimum of 2 years in the audit division. A majority (67.5 %) of respondents expressed the wish to pursue their career within the audit firm they work for either in the audit department or in another division. 23 % of the subjects expressed the will to move either to commerce or to industry. 3 % of the subjects considered that they wished to change their career paths entirely.

Due to the anonymity of respondents it was not possible to analyse the firm effect; that is, the distribution of responses across firms, or whether there were any significant differences between firms, in particular in their operational methodological approaches to audit.

6.3 Incidence of recognition of a potential fraud flag and/or NAS opportunity within the structured audit approach

Concerns over the auditor's ability to recognise a fraud flag and/or NAS opportunity reflect the tensions between independent judgement and the structure of the audit task. The incidence of auditors' recognition of a fraud flag and/or NAS opportunity is based upon the audit planning memorandums individually composed by the subjects. The question is whether auditors can see beyond the conventional audit practice of 'risk-based' auditing and are capable of spotting a fraud flag and/or NAS opportunity in the K plc case by interpreting the given material on K plc's performance and overall environment over a broader scope of judgement.

In the study, those subjects who recognised a fraud flag and/or NAS opportunity in either year of treatment were perceived as 'big picture' practitioners. The term 'big-picture' relates to practitioners who apply freer, more holistic scope in judgement processes, and are able to look 'outside the square' (Percy, 1999). The subjects unable to see either a fraud flag or NAS opportunity in the K plc case were perceived as more conventional practitioners; this often relates to the practice of 'ticking the right boxes' with 'black box' oriented judgements. In this study the auditors were expected to change scope in their judgements according to the circumstances of K plc (the characteristics of K plc vary substantially across the three cases A, B, C) (sections 5.3 of chapter 5 presented case study design).

Thus, the null and alternative hypotheses were tested $\alpha=0.05^1$:

H0: The auditors adopt a standard (conventional) approach to audit across cases irrespective of the client's situation.

¹ The choice of $\alpha=0.05$ is a commonly accepted level of significance; although this has been questioned as an arbitrary figure (Siegel and Castellan, 1988).

H1: There are differences in the approach to audit among the auditors across cases.

These hypotheses were tested by examining the conventionality of the audit approach across cases; that is, the actual proportion of ‘big-pictured’ and conventional auditors. Chi-test checked for independence of samples of ‘big-pictured’ and conventional auditors across the pairs of cases. If there was no statistically significant difference in the proportion of auditors adopting conventional as opposed to ‘big-pictured’ judgmental approaches with regard to the K plc ‘s audit across cases (across pairs of cases A and B, B and C, C and A), the null hypothesis would not be rejected. If the pairs of cases differed significantly in proportion of auditors adopting conventional, as opposed to ‘big-picture’ judgement scopes with regard to the K plc’s audit (cases A and B, B and C, C and A), the null hypothesis would be rejected and alternative hypothesis accepted.

Tables 6.3 and 6.4 present a summary of the results associated with the incidence of the recognition effect in year 2 of the treatment. In year 2, in addition to the presence of NAS opportunity, fraud flags were introduced in each case.

Table 6.3
Recognition effect across cases – year 2 of treatment for $\alpha=0.05$

<i>Case Group</i>	<i>A</i>		<i>B</i>		<i>C</i>		<i>Overall</i>	
‘Big-pictured’	9	32%	16	73%	19	78%	44	59.5 %
‘Conventional’	19	68%	6	27%	5	21%	30	40.5 %
Overall	28		22		24		74	100 %

CHITEST 0.0008648 (statistical significance 99.91 %)

Table 6.4
Recognition effect across pairs of cases – year 2 of treatment for $\alpha=0.05$

<i>CASES</i>	<i>CHITEST</i>	<i>STATISTICAL SIGNIFICANCE</i>
A AND B	0.004385	99.56 %
A AND C	0.000706	99.92 %
B AND C	0.628181	37.18 %

Out of all the subjects in the treatment, 59.5 % (hereafter 'big-pictured') recognised either a fraud signal or NAS opportunity. The remainder, i.e. 40.5 % of subjects (hereafter 'conventional' practitioners) did not see beyond the standard audit practice of risk/materiality assessment (Table 6.3).

Hence, the judgmental processes of 40 % of the entire population were embedded in a somewhat narrower scope judgements in which boundaries were determined by the structure of the audit process. The proportion of 'big-pictured' differs across cases (statistically significant: 99.91 %). These differences are statistically significant between case A and case B, and between case A and case C (Tables 6.4). Therefore, the null hypothesis that the auditors adopt a standard (conventional) approach to audit across cases irrespective of the client's situation is rejected for the pair of cases A and B, and for the pair of cases A and C. Thus, the alternative hypothesis regarding the existence of different approaches to audit in these two pairs of cases (A and B, A and C) is accepted. A statistically significant conclusion with regard to the differences in the applied audit approaches cannot be reached with regard to cases B and C. These results are not surprising since the existence of fraud flags is evident in both cases B and C. Case A, however, involves the least obvious fraud flag, encouraging conventional audit behaviour (subsequent minority of 'big-pictured', that is 32 % of the subjects). In cases B and C, with more obvious fraud flags, there is still 27 % (case B) and 21 % (case C) of the subjects functioning in a conventional mode.

It could be speculated that the degree of recognition does not depend on a size of 'big-picture' (i.e. the extent of 'big-picture' capacities). This can also indicate that there is a level of materiality threshold at which some auditors are able to switch their judgmental orientation from conventional mode to 'big-picture' mode, i.e. the versatile group. In addition, it could be argued that there may be a sub-group of the auditors who despite of the existence of the fraud flags, stay within the 'black-box' orientation judgements (either unable or unwilling to label the problem of fraud).

On the whole, it was expected that auditors would recognise the fraud flag and/or the NAS opportunity at a higher rate across these cases given the characteristics of the K plc's environment and associated riskiness.

In addition to the analysis of the recognition effect across cases, the individual comments cited in the memorandum were examined. In the narrative part of the memorandum, where the auditors had to list the most important points with regard to the economic reality of K plc for the audit planning purposes, the subjects made on average 3.3 comments in year 1 and subsequently 3.1 in year 2.

Out of all cited comments in the audit memorandum, 93 % (in year 1 of treatment) and 79 % (in year 2 of treatment) did not refer to either NAS opportunity or material misstatements (i.e. fraud) and thus, these comments fall into the category of ‘Conventional audit practice’ (Table 6.5). It can be argued that the auditors’ individual interpretations of the overall situation at K plc reflect a rather narrow scope of judgements.

Table 6.5
The auditors’ discourse in the audit planing memorandum: Frequency of comments

<i>Memorandum comments</i>	<i>Year 1</i>		<i>Year 2</i>		<i>Δ%</i>
	Frequency	%	Frequency	%	
1. Conventional audit practice	226	93.0	184	79.0	-0.15
2. Potential fraud recognition	4	1.6	35	15.0	8.37
3. Recognition of NAS	13	5.4	14	6.0	0.11
Overall	243	100	233	100	-

The obduracy of K plc’s problem (i.e. an error in the sales system carried over from year 1 to year 2 of treatment) as well as the more evident presence of the fraud flags in year 2, reinforced the auditors’ concerns with regard to potential fraud. The frequency of auditors concerns over fraud increased to 8.3 % in year 2 (Table 6.5).

It can be argued that auditors find it difficult to transcend the structure of ‘risk-based’ auditing. Does it mean that structuration of the audit process ‘bands’ a ‘big picture’ orientation in the audit judgement?

6.4 Incidence of the auditors’ anchorage

This section presents the incidence of the auditors’ anchorage. Most of the early NAS recognisers in year 1 of treatment (NAS1) switched the ‘anchor’ of their concerns in year 2 and recognised a fraud flag (F2). Out of all early NAS recognisers² (NAS1) 93 % became recognisers of fraud in period 2 (F2). Out of all non-recognisers from year 1 (C1) 30.6 % became recognisers of fraud in year 2 (F2) (Table 6.6).

² In year 1 of treatment only one subject mentioned potential existence of fraud and even then not explicitly. Therefore this minimal incidence of fraud recognition in year 1 of treatment had been omitted in the analysis.

Table 6.6
‘Switch effect’ - recognition of fraud

<i>NAS1</i> *		<i>F2</i>		<i>NAS2</i>		<i>C2</i>	
Yes	15	14	93 %	1	7%	-	
No	59	18	30.6 %	11	18.6%	30	50.8%
Overall	74	32	43.2 %	12	16.3%	30	40.5%

* Includes F1 (1 subject)

Hence, early NAS recognisers (NAS1) tend to switch to fraud recognition, but initial recognition is affected since late NAS recognisers (NAS2) seem to be deflected from recognition of fraud. In the latter group there is the risk of apparent independence threat: those subjects may use the conventional structure of audit in order to avoid engagement with fraud problem regardless of their awareness of evident fraud clues. The dynamics of NAS opportunism, deflecting the probability of fraud recognition, could be an area addressed in further research, in particular issues of apparent organisational independence. Further, it could be argued that the structure in audit somewhat ‘bands’ the ‘big picture’ judgmental orientation of the auditor in the sense of delaying fraud recognition.

It could be argued that the recognition of fraud and of the NAS opportunity are mutually exclusive since auditors do not consider NAS opportunities and fraud signals simultaneously in the same period of treatment. In other words, there is tentative evidence of the reluctance of both early and late NAS recognisers (NAS1 and NAS2) to recognise a fraud signal and an NAS opportunity in the same period of treatment. Such evidence may suggest the ability of some practitioners to switch their attention to adapt to a new situation: when the underlying circumstances are evident of fraud and/or NAS opportunity some auditors are prepared to see the client in a wider scope and are capable of versatile judgements. Such auditors are treated as operating within a ‘big-pictured’-versatile mode of judgement.

6.5 Incidence of auditors’ consistency with regard to the structure of the audit determined by the directions of assessed risk and estimated hours for audit testing

Consistency with regard to the direction of risk and the audit testing applied in year 1 and year 2 of treatment across the groups identified by the incidence of anchorage of individual judgements, i.e. NAS1 and C1 for year 1 and NAS2, F2, C2 for year 2 is examined by Chi-test (section 6.4).

The degree of conformity with the routine of risk assessment and audit hours estimations determines the structure consistency of judgement in 'risk-based' auditing. Those auditors who applied changes in the estimation of audit risk and the budget for audit testing from year 1 to year 2 in the same direction and applied either same, higher, or lower estimates for risk and audit hours were perceived as consistent with regard to the structure of the audit approach (i.e. SS, HH, LL). Those who applied those changes in different directions were perceived as inconsistent with regard to the structure of the audit approach (i.e. HS, HL, SH, SL, LS, LH).

Conformity with the structure of the audit task were examined across the four different groups of auditors ($C1 > C2$, $NAS1 > F2$, $C1 > F2$ and $C1 > NAS2$) previously identified by the following hypotheses for $\alpha=0.05$:

H0: There are no differences in consistency with regard to estimations of risk and hours for audit testing from year 1 to year 2 of treatment among auditors ('big-pictured'-early NAS recognisers ($NAS1 > F2$), late NAS recognisers ($C1 > NAS2$), fraud recognisers ($C1 > F2$), and conventional auditors ($C1 > C2$)).

H1: There are differences in consistency with regard to estimations of risk and hours for audit testing from year 1 to year 2 of treatment among auditors ('big-pictured'-early NAS recognisers ($NAS1 > F2$), late NAS recognisers ($C1 > NAS2$), fraud recognisers ($C1 > F2$), and conventional auditors ($C1 > C2$)).

These hypotheses were tested by examining the actual differences in structure consistency of 'risk-based' auditing; that is, differences in directions with regard to estimation of risk and hours for audit testing from year 1 to year 2 of treatment among the auditors. Chi-test checked for the independence of samples of those individuals who were consistent with the structure and those inconsistent with the structure across the pairs of the auditors ('big-pictured'-early NAS recognisers ($NAS1 > F2$), late NAS recognisers ($C1 > NAS2$), fraud recognisers ($C1 > F2$), and conventional auditors ($C1 > C2$)). If there were no statistically significant difference in the proportion of consistent auditors, as opposed to inconsistent auditors, among the pairs of the auditors, the null hypothesis would not be rejected. If there were a statistically significant difference in this proportion among the pairs of the auditors, the null hypothesis would be rejected and the alternative hypothesis accepted.

Conformity with the structure of the audit task across the groups of auditors (determined by the anchorage of their judgements in section 6.4) is presented in Tables 6.7 and 6.8.

Table 6.7

Structure consistency between the groups of auditors – recognition effect for $\alpha=0.05$

<i>Direction</i> (risk/audit testing)	<i>NAS1 > F2</i>	<i>C1 > F2</i>	<i>C1 > NAS2</i>	<i>C1 > C2</i>	<i>ALL</i>
HH, SS, LL	8 57 %	16 89 %	3 27 %	21 70 %	48 66 %
HS, HL, SH, SL, LS, LH	6 43 %	2 11 %	8 73 %	9 30 %	25 34 %
Overall	14 19 %	18 24 %	11 16 %	30 41 %	73 100 %

CHITEST 0.00704 (Statistical significance: 99.29 %)

Early NAS recognisers, who switch to fraud recognition (NAS1>F2), were less consistent with the structure of the audit process (57 %) in comparison with the entire sample (66 %) (significance level: 99.3 %). Early conventional auditors (C1) split their judgmental scope towards fraud (F2) or NAS recognition (NAS2), or remained as the conventional group (C2). Out of all the subjects, 24 % were able to spot fraud flags, of which 89 % were following the demands of logic of ‘risk based’ auditing (C1>F2). A further 16 % of all the subjects did not ‘see’ fraud but spotted the NAS opportunity in the second year (C1>NAS2) while being inconsistent with regard to the structure of audit process (73 %); that is, in most cases these auditors increased the risk but not hours for testing, or even decreased the hours (Table 6.7). It seems that NAS opportunism deflected those auditors from the recognition of fraud (whether this was deliberate or reflected the structured, mechanistic learning in the profession may be an area addressed in further research).

Table 6.8

Structure consistency between the groups of auditors – recognition effect for $\alpha=0.05$
Chi-tests

<i>GROUPS</i>	<i>CHITEST</i>	<i>STATISTICAL SIGNIFICANCE</i>
NAS1>F2 AND C1>F2	0.003965	99.60 %
C1>F2 AND C1>NAS2	0.000722	99.92 %
C1>F2 AND C1>C2	0.119528	88.04 %
NAS1>F2 AND C1>C2	0.412903	58.70 %
NAS1>F2 AND C1>NAS2	0.135305	86.46 %
C1>C2 AND C1>NAS2	0.001384	99.86 %

A significant proportion of auditors (41 %) did not recognise fraud despite the existence of fraud signals in K plc's case material ($C1 > C2$). Those auditors, however, were very consistent (70 %) in comparison with all the subjects (66 %), most versatile group ($NAS1 > F2$) (57%) or late NAS recognisers (27 %). It seems that the 'big-pictured' - NAS recognisers did not conform to structure as much as conventional auditors and the group of fraud recognisers. Further, the group of versatile 'big-pictured' ($NAS1 > F2$) was less consistent (57 %) in comparison with late fraud recognisers (89%), but more consistent in comparison with late NAS recognisers (27%) (Table 6.7).

The statistically significant differences in auditors' structure consistency are evident between the groups of (1) fraud recognisers ($C1 > F2$) and late NAS recognisers ($C1 > NAS2$) (significance level 99.92 %), (2) conventional auditors ($C1 > C2$) and late NAS recognisers ($C1 > NAS2$) (significance level 99.86 %), and (3) 'big-pictured'-versatile ($NAS1 > F2$) and fraud recognisers ($C1 > F2$) (significance level 99.60 %) (Table 6.8). In these three cases, the null hypothesis regarding no differences in the auditors' structure consistency is rejected and the alternative hypothesis accepted. The differences in auditors' structure consistency in the groups of fraud recognisers and late NAS recognisers, and in the groups of conventional auditors and late NAS recognisers indicate an apparent independence threat; that is, the group of late NAS is less consistent with regard to the structure of 'risk-based' auditing since the auditors tend to remain or even decrease the number of hours for audit testing despite an increase of the risk in K plc.

It seems that in the groups of 'big-pictured'-versatile and fraud recognisers the majority of auditors is risk averse. That is, the characteristics of K plc in the first year of treatment did not explicitly point towards fraud. Further, an NAS opportunity was not a motivational driver for an increase of the overall risk. Thus, only the second year with obvious fraud indicators triggered an increase of the risk among auditors. This is inconclusive and would require further investigation as to the attitudes to risk among auditors, in particular with regard to risk aversion.

We cannot arrive at the statistically significant conclusion about the differences in auditors' structure consistency (1) between the groups of fraud recognisers ($C1 > F2$) and conventional auditors ($C1 > C2$), (2) between the groups of 'big-pictured' versatile auditors ($NAS1 > F2$) and late NAS focused ($C1 > NAS2$), and (3) between the groups of 'big-pictured'-versatile ($NAS1 > F2$) and conventional auditors ($C1 > C2$). Thus, in these three cases we can not either reject the null hypothesis nor accept the alternative hypothesis (Table 6.8). The incidence of early NAS recognisers staying with NAS recognition in year 2 was minimal (only one subject in the treatment), therefore it is impossible to check this group for structure consistency. The

combination of early NAS recognisers becoming conventional in year 2 of treatment (NAS1>C2) did not occur in the study.

6.6 Auditors' consistency with regard to the structure of the audit determined by the levels of estimated risk and a number of budgeted audit hours for audit procedures.

Consistency with regard to values of the assessment of risk across the groups identified by the incidence of anchorage and across the cases is examined by Spearman Rank-Ordered Correlations and analysis of variance by ranks, that is the Kruskal-Wallis test. The values of the assessed risk were determined through the use of a 7-point Likert scale where 1 represented negligible risk, 7 extremely high risk, and the median of 4 represented moderate risk.

The question is whether the judgements regarding the level of risk and number of hours assigned for audit testing are associated (in year 1 and in year 2 of treatment). Thus, the following hypotheses may be tested in year 1 for $\alpha=0.05$:

H0: Judgements regarding the level of risk and number of hours for audit testing are not positively correlated among the auditors in year 1 of treatment (the groups of auditors include 'big-pictured'-early NAS recognisers (NAS1>F2), late NAS recognisers (C1>NAS2), fraud recognisers (C1>F2), and conventional auditors (C1>C2)).

H1: There is a positive correlation between these judgements among the auditors in year 1 of treatment ('big pictured'-early NAS recognisers (NAS1>F2), late NAS recognisers (C1>NAS2), fraud recognisers (C1>F2), and conventional auditors (C1>C2)).

In the second year these hypotheses were restated for $\alpha=0.05$:

H0: Judgements regarding the level of risk and number of hours for audit testing are not positively correlated among the auditors in year 2 of treatment (the groups of auditors include 'big-pictured'-early NAS recognisers (NAS1>F2), late NAS recognisers (C1>NAS2), fraud recognisers (C1>F2), and conventional auditors (C1>C2)).

H1: There is a positive correlation between these judgements among the auditors in year 2 of treatment ('big pictured'-early NAS recognisers (NAS1>F2), late NAS recognisers (C1>NAS2), fraud recognisers (C1>F2), and conventional auditors (C1>C2)).

The Spearman rank-order test examines correlations between the level of risk and the number of audit hours assessed in year 1 and year 2 of treatment between groups of recognisers of NAS opportunity or/and of potential fraud and conventional auditors (Table 6.9).

Table 6.9
Spearman rank-order correlation coefficient Rs – recognition effect

<i>Group</i> <i>Year</i>	<i>NAS1>F2</i>	<i>C1>F2</i>	<i>C1>NAS2</i>	<i>C1>C2</i>
1	0.039	0.450	0.020	0.403
2	0.355	0.504	0.320	0.511

We can observe stronger correlations between the assessment of risk and the number of hours of more conventional auditors (C1>C2) in comparison with the group of ‘big-pictured’ versatile (NAS1>F2) and late NAS recognisers (C1>NAS2). Further, late fraud recognisers (C1>F2) have similar correlations to conventional auditors (C1>C2). It seems that late NAS recognisers and ‘big-pictured’ versatile have a higher propensity to be less consistent with regard to the structure of the audit task. The results of this test are indicative but not conclusive. Further research is required to substantiate these results.

Structure consistency with regard to risk (i.e. between the level of risk and the number of audit hours assessed in year 2 of treatment) can be checked across the three cases (A, B, C). Hence, the following hypotheses with regard to risk consistency (association between judgements regarding the level of risk and number of hours assigned for audit testing) across cases are tested for year 1 and 2 of treatment:

H0: Judgements regarding the level of risk and number of hours for audit testing are not positively correlated among the auditors across cases in year 1 of treatment.

H1: There is a positive correlation between these judgements among the auditors across cases in year 1 of treatment.

In the second year these hypotheses were restated:

H0: Judgements regarding the level of risk and number of hours for audit testing are not positively correlated among the auditors across cases in year 2 of treatment.

H1: There is a positive correlation between these judgements among the auditors across cases in year 2 of treatment.

We observe rather weak correlations between the assessment of risk and audit hours across cases (Table 6.10). The strongest correlation between risk and hours can be observed in case B incorporating the strongest fraud flag.

Table 6.10
Spearman rank-order correlation coefficient Rs – case effect

<i>Case</i> <i>Year</i>	<i>A</i>	<i>B</i>	<i>C</i>	<i>All</i>
1	0.289	0.537	0.194	0.289
2	0.375	0.604	0.238	0.450

Overall these correlations illustrate the relatively weak association of risk and hours assessments implying (1) the problem with auditors’ consistency in judgement processes and (2) the effects of the other elements of the audit milieu on independent judgement, unexplained by the statistical testing. These hidden elements relate to structural conditions, social institutions, power relations, etc.

One way analysis of variance (ANOVA) between the groups of non-recognisers (conventional auditors), fraud recognisers and the NAS focused, allows closer examination of the risk assessments in both periods of treatment between the groups of auditors determined by anchorage of their judgements (section 6.4). Any differences attributable to the different exposures in respect of the client’s management response embody the different management service opportunity. Thus, the experiment is designed to assess both awareness of, and sensitivity to, those factors which are addressed in the experiment. A significant main effect across the groups implies that the auditors’ judgements varied systematically (i.e. median performance of risk assessment). The null hypothesis is that the groups of non-recognisers (conventional auditors), fraud recognisers, and NAS focused come from the same population with the same median performance of risk assessment. The alternative hypothesis implies that the groups of auditors differ in the median performance with regard to risk assessments. Thus, in year 1 of treatment the following hypotheses were formulated for $\alpha = 0.05$:

H0: There is no difference in the median of risk assessments between the group of conventional auditors (C1), fraud recognisers (F1) and NAS focused (NAS1) in year 1 of treatment.

H1: These groups of auditors differ in the median with regard to risk assessments in year 1 of treatment.

Similarly, in year 2 of the treatment the following null and alternative hypotheses were formulated for $\alpha = 0.05$:

H0: There is no difference in the median of risk assessments between the groups of conventional auditors (C2), fraud recognisers (F2), and NAS focused (NAS2) in year 2 of treatment.

H1: These groups of auditors differ in the median performance with regard to risk assessments in year 2 of treatment.

The results of the Kruskal-Wallis (KW) test, a non-parametric version of one-way analysis of variance, for the risk assessments are presented in Table 6.11.

Table 6.11
Risk assessments across the recognition effect for $\alpha = 0.05$

Year	<i>KW</i>	<i>(p)</i>	<i>Statistical significance</i>
1		0.0045	99.55 %
2		0.0987	90.13 %

Table 6.11 demonstrates that in year 1 of treatment we can reject H0 at the probability 99.55 %. The groups of early conventional auditors (C1), fraud recognisers (F1) and NAS focused (NAS1) assessed the risk in a different manner. In addition, the means of risk performance were calculated. The means of risk assessments were $M=4.0$ for conventional auditors and $M=4.99$ for ‘big-pictured’ (in year 1 fraud recognition is minimal, therefore the group of ‘big-pictured’ was analysed as one). These suggest that the group of ‘big-pictured’ assessed a higher rate risk of 1 point.

In year 2 of the treatment we cannot reject H0 as there is no difference in the median performance of risk assessment between fraud recognisers (F2), NAS recognisers (NAS2) and conventional auditors (C2). Table 6.11 implies that these groups assessed the risk in a similar manner in year 2 of the treatment. Similarly, the means of risk performance were estimated. $M=4.41$ for

conventional auditors and $M=4.31$ for the group of 'big-pictured' (subsequently $M=4.28$ for NAS focused and $M=4.44$ for fraud focused).

It could be speculated that auditors on the whole are risk averse. It indicates that the auditors regard the risk as somewhat less in instances when they can understand it and control it. Thus, since the fraud flags are evident in year 2 of treatment, risk aversion did not allow for significant differences in the median performance of risk assessment between fraud recognisers, NAS recognisers and conventional auditors.

On the whole the Kruskal-Wallis test does not allow to see into individual thought processes associated with independent audit judgement. Risk perception is thus a simplistic surrogate for such insights. The following chapter (chapter 7) on the basis of narrative analysis reports on individual thought processes in audit judgement.

Analysing the incidence of the auditors' consistency with regard to the structure of the audit process and the risk values (Tables 6.6 - 6.10), it could be argued that the majority of conventional practitioners ($C1>C2$) were more compliant with the structure while the group of versatile 'big-pictured' ($NAS1>F2$) and late NAS recognisers ($C1>NAS2$) had a higher propensity to transcend the structure of the audit process. Alternatively, the independence from the client may have been threatened, in particular in the group of NAS recognisers: they seem to be operationally independent but apparent independence is at risk. It could be argue that these auditors may use conventional structure of the audit process as a mask in order to avoid engagement with the fraud problem despite their awareness of fraud clues. In addition, other effects of the audit judgement milieu, unexplained by the statistical analysis 'shadow' the assessments of risk and audit hours.

6.7 Summary

This chapter presented the results of the statistical analysis of the questionnaire data. The examination of the anchorage of the auditor's judgements made in the audit planning memorandum allowed the determination of two different groups of auditors consistent with there being different attitudes to structure and judgement metaphors: (1) conventional auditors focused predominantly on risk and materiality assessments, and (2) 'big-pictured' – sub-divided between (i) versatile including those auditors who were able to switch their 'big-picture' scope of judgement over the two years of treatment, and (ii) switchers from a conventional mode in year 1 to 'big-picture' mode in a second year of treatment. Into the 'big-pictured' category fall those auditors who recognised either an NAS opportunity or a fraud flag (in either year of treatment); that is, 'NAS focused' and 'fraud focused'. Those auditors who switch their judgements from NAS recognition in year 1 of the treatment to fraud recognition in the second year of the treatment

(NAS1> F2) represent the sub-group of versatile-‘big-pictured’ learners. This group demonstrated a wider scope of judgement.

From the analysis of the auditors’ consistency with regard to the structure of the audit approach embedded in ‘risk-based’ auditing, it could be argued that the majority of conventional auditors (70 %) were more compliant with the structure of the audit task in comparison with the group of ‘big-pictured’ (in particular in the sub-group of versatile-‘big-pictured’ (NAS1>F2) (57 %) and late NAS recognisers (C1>NAS2) (27 %). An alternative explanation for these differences in structure consistency could be associated with an apparent independence threat, in particular in the group of late NAS recognisers. Despite awareness of fraud signals and subsequently of the higher risk, 73 % of those auditors tended not increase (adjust) the budget of hours for audit testing. They seemed to be ‘deflected’ from fraud recognition.

In short, what emerges from the study is evidence that auditors respond to the (changing) circumstances of the K plc client’s environment in different ways, consistent with their attitudes to structure of the audit process: transcending and non-transcending. The former being less constrained by the structured audit approach represents a ‘big-picture’ perspective (‘big-picture’-versatile, i.e. NAS1>F2, and switchers to ‘big-picture’ mode, i.e. C1>F2 and C1>NAS2). In the latter group of more conventional auditors, structure ‘bands’ the ‘big-picture’ judgement orientation; hence, these auditors tend to take to codification more readily following risk and materiality steps, and that results in ‘black box’ oriented judgements.

On the whole, 40 % of the subjects did not see either a fraud flag or an NAS opportunity in K plc despite the characteristics of the case; that is, they did not ‘see’ beyond risk and materiality concerns. On the whole, the group of conventional auditors by conforming to the format of ‘risk-based’ audit methodologies was unable to ‘see’ the client through the wider lenses. These auditors may prone to operational independence threat. It could be argued that some auditors were unwilling to see a ‘big-picture’ scope judgements and despite the awareness of fraud clues chose not to engage with fraud problem following ‘blindly’ the format of materiality and risk assessments. These auditors prone to an apparent independence threat which is ‘masked’ by an operational independence threat. In other words, those subjects may have used the conventional structure of audit in order to avoid involvement with fraud regardless of their knowledge of fraud flags. Thus, the evidence reveals that a structured approach is overused in audit and forms an obstacle to the recognition of material fraud.

Further, the mutual exclusivity of fraud and NAS recognition was found since auditors did not consider a fraud flag and a NAS opportunity simultaneously in the same year of treatment. Such evidence suggests the ability of some practitioners to switch their attention to adapt to a new

situation and their capacity for versatile judgements. 'Big-pictured'- versatile practitioners (NAS1>F2) and switchers-versatile practitioners (C1>NAS2 and C1>F2) fall into the category of 'big-picture' auditors.

This chapter reported on statistical analysis with regard to independence of judgement within the structured audit approach. The results provide limited insight as to the individual thought processes associated with audit judgement. Although non-parametric analysis offers a number of tests, their somewhat limited power is unable to grapple in depths with the sophistication of individual auditors' thinking and interpretations. The following chapter (chapter 7) on the basis of narrative analysis reports on the more ambiguous aspects of the individual auditor's thought processes, unveiled by the statistical analysis and embedded in dynamics of the audit judgement milieu (see section 3.5 in chapter 3).

CHAPTER 7

The realm of the real in audit practice

7.1 Introduction

This chapter discusses the ways in which professionals perceive themselves both as the members of a distinct profession and as the members of a particular audit firms and seeks to reveal whether they value the independence of their judgements. Interviews were designed to draw upon and enter into dialogue with auditors' individual discourses concerning their perceptions and attitudes of on-the-job performance. In particular, narrative analysis set out to clarify how selected participants perceive themselves as dealing with the tensions between structure and judgement metaphors and how they relate these perceptions to their personality and background. Hence, the more ambiguous aspects of audit judgement processes, which had remained opaque in the statistical analysis are brought to light. Insights from interviews' narratives confirmed the existence of different attitudes to tensions between judgement and structure in the audit process; that is, the two distinct groups of transcending (with a 'big-picture' scope) and non-transcending (with a conventional scope) practitioners emerged.

To find out whether audit independence is compromised in the organisational context, in particular in its operational sense, there was a need to investigate individual perceptions and awareness of the capacity for provision of the audit services, and how this awareness manifests itself in patterns of judgement and decision-making. Further, as audit firms encourage certain ways of being, that is certain behaviours on audit, the question of whether the firms promote awareness for additional services, that is NAS opportunism was raised. In addition, the dynamics between the organisational culture towards judgement styles and individual interpretations is examined. In this sense, an identification of *who* the auditors are and *what* they are may form the basis of an understanding of their position in particular social situations within the audit firm. It can be argued that all knowledge is subjective; that is, what we know is shaped by how we know it and who we are. Hence, this chapter provides insights into individual experiences of the dynamics between audit judgement and the structure of the audit process within the audit firm in the form of stories and events related by the auditors themselves.

This chapter is organised as follows. Firstly, the demographic characteristics of interviewees are presented. The next section is devoted to the presentation of the story of the 'realm of the real' in operational audit practice formulated through the auditors' discourses themselves. Within that story, the auditors present their experiences of socialisation processes within the firm, i.e. the role of the audit firms in the formation of auditors' awareness (the predisposition to audit). The

story is told with the application of symbolic language where the dynamics between judgement and structure metaphors are revealed in the hermeneutic context of the practice. What emerges from the story is the unfolding of organisational change and associated concerns related to the introduction of the new audit methodologies. The following section discusses the personality of the auditor and how individual traits influence particular responses to judgement processes and to the structure of operational approaches. Finally, the ‘realm of the real’ in operational audit approaches is compared with the wished for and imagined state; that is, the auditors share how they perceive directions for further change with regard to the improvement of audit quality.

7.2 Profile of interviewees

Out of the 74 participants of the questionnaire survey, 10 individuals were selected to be invited for an interview (5 audit seniors and 5 audit managers); that is, 13.5 % of all participants of the questionnaire survey. All 10 agreed to participate,. The interviewees were chosen from two Big Five auditing firms - PriceWaterhouseCoopers and Arthur Andersen. There was a relatively even distribution of interviewees across the three cases A, B, C. Table 7.1 presents the across-case distribution.

Table 7.1
Interviews’ respondents: Across-case distribution

<i>Case</i>	<i>A</i>	<i>B</i>	<i>C</i>
<i>Position in the firm</i>			
<i>PriceWaterhouseCoopers</i>			
Audit Senior	1	1	1
Audit manager	1	1	
<i>Arthur Andersen</i>			
Audit Senior	1	1	
Audit manager	1	1	1
Overall	4	4	2

The demographic characteristics of the interviewees and their experience in the auditing profession are summarised in Table 7.2. This table demonstrates a representative distribution of age groups, audit experience within the firms and gender of the interviewees.

Table 7.2
Interviews' respondents: Demographic characteristics and work experience

<i>Experience in audit (yrs)</i>		<i>Up to 3</i>		<i>4 – 5</i>		<i>6 - 7</i>		<i>8+</i>	
<i>Gender</i>		<i>F</i>	<i>M</i>	<i>F</i>	<i>M</i>	<i>F</i>	<i>M</i>	<i>F</i>	<i>M</i>
<i>Age</i>									
20-30			1						
31-40				1	1	1	1		
41-50					2		1		1
50+									1
Overall			1	1	3	1	2		2

F – Female, M - Male

7.3 The story of the 'realm of the real' in audit practice

In this study, the auditing practice is perceived as a hermeneutic practice; that is, the auditor on the job strives to understand and interpret the economic text behind the client's operations and financial statements in the wider contexts of social institutions, power relations and structural conditions. The auditor's engagement with clients is also shaped by where the auditor is coming from, which can be understood as originating from the dynamic fusion of individual traits and immersion in specific professional and organisational cultures. With a focus on each auditor's own description of on-the-job experiences, this section seeks to illuminate the multiplicity of interpretive dimensions and multifaceted nature of the 'realm of the real' in audit practice. As part of the story of professional formation, the auditor is required to complete socialisation process within the audit firm, during which understandings of its internal culture and politics are absorbed. The story is composed of its own symbolic language, rich in professional jargon and often linked to emotional and intuitive aspects of experience. The story requires an overview of the context; that is, embeddedness in the dynamics between judgement and structure metaphors. Tensions that exist between the auditor and the role of the firm in predisposing to audit are discussed through individuals relating their ways of navigating and adopting to organisational change, i.e. the introduction of new audit methodologies. Hence, the story of the 'realm of the real' records different accounts and different viewpoints of operational reality, and then, constructs what appears to be the (perceived) best in its text to be shared.

7.3.1 Socialisation processes

Organisational age; that is, the number of years the individual has been employed by or associated with an organisation, influences the perceptions of this individual, in particular with regard to structural conditions and power relations within the organisation. Within audit firms, the process of socialisation is tacitly understood as an informal but utterly necessary rite of

passage in which, through a series of learning experiences, trials and tests, the individual demonstrates that he/she has absorbed particular norms and procedures, and can bring these to effect in an appropriate manner. Hence, the time the auditor has spent in the audit firm (i.e. organisational age), and in particular in the audit division, has an effect on his/her perceptions of the underlying reality of that firm and brings particular insights into how audit is done. The auditors argued that it takes generally up to three years for an individual to become socialised into the internal culture. That is, during the first two or three years of employment the auditor learns the ways, norms, procedures and perspectives. It is also during this period of the first years that newcomers are more questioning of these organisational ways of 'how things are done'. After the socialisation process is completed or nearly completed, organisational routines and procedures are taken for granted and inscribed in tacit ways in daily operations. There is a danger that structure will become inscribed into individual decision processes if the auditor's self-awareness and tenacity to his/her capacities for creative and critical reasoning is somewhat obfuscated by procedural concerns. All interviewees had at least two or three years of audit experience in the current firm, and had therefore all more or less completed the initial socialisation processes with this firm. Andrew (one of the interviewees) explained that when this initial process is undergone, individual thinking processes are identified very much with the 'thinking' of the organisation.

'Your thinking becomes very much the case of the firm's view rather than of your own. It has to do with the whole culture of the firm. Auditors feel as being a part of the firm. We [auditors] are encouraged to take responsibility for the firm's culture and consult on things. It is a part of this profession, you find a consensus on how to manage the risks' (Andrew).

Ernie pointed out the importance of broader individual creativeness, especially in these first three years of job experience.

'When you join the audit firm, the first three or four years are very much task-driven, you are focusing on individual tasks each year. But you need to somehow broaden your creative thinking at all levels, you need to gain business awareness' (Ernie).

Ernie pointed out that during these first years in the audit firm the auditor learns the 'craft' of auditing; that is, the auditor becomes predisposed to audit.

'You start to look at things in one way at the university. You learn to look at things in a particular way. You then feed it to the auditing processes and you start to look at things in more analytical manner to start with. And then, you have to try to broaden your thinking. That is very important. It is like a learning process' (Ernie).

Incentives for changes in auditing careers are very much self-driven and self-defined. For the majority of interviewees a personal conviction was a motivational driver in the process of choosing the audit firm for auditing training. Motivation factors for good audit performance whilst within the firm were associated with possession of specialised knowledge inaccessible to others (i.e. exclusive professional knowledge), status, salary, and inclusive social culture (in particular acknowledgement of colleagues). Possession of status (related to prestige in society) and of professional knowledge (expertise) were highly regarded by the majority of interviewees in the assessment of their job satisfaction. Some auditors mentioned primacy of financial reward as a determinant of job satisfaction. For example Stephen stressed the importance of his salary as motivational factor to perform well in the audit practice.

‘Audit is quite an interesting and rewarding discipline, by the end of the month I am satisfied with my pay slip’ (Stephen).

Social aspects of work were also perceived as important for the interviewees’ job satisfaction. On the whole, in both firms, auditors are perceived to engage themselves on the basis of the specific task at hand. Auditors often co-operate with one another in teams in order to achieve timely goals; that is, a successfully completed audit. Sarah stressed that she values a friendly atmosphere at her work place.

‘I appreciate working in the firm, we have a friendly team-building atmosphere, this defines what we are and how we work’ (Sarah).

The interviewees perceived that, on the whole, auditors at senior/managerial levels enjoy what they do in audit because of their intrinsic interest in the task. They argued that those so-called simple procedures of ticking and trial balancing belong to the responsibilities of junior members of the audit teams. Often junior members of the audit team are patronised with regard to their critical skills, which somewhat contradicts the concept of a socialisation process within which auditors viewed themselves as being critical of internal culture. John argued from the perspective of the team manager.

‘You have to have a lot of understanding about the level and the stage of each member of the team...and as they [junior staff] progress you would hope that their structured thinking would become less rigid, and that they should be able to think for themselves, to think problems through themselves’ (John).

Ann and Russell gave examples of the progression process within the audit firm.

'In the first year you do photocopies and adding up, in the second year you do a bit more, you do trial balances, and in the third year you get many more responsibilities. This is how you progress, how it all works in the auditing environment' (Ann).

'At higher levels [managerial levels] in the firm you are encouraged to be more of a 'big-pictured' thinker, your role is more focused on whether the client's accounts show a true and fair view. Although, when you are in the first years of auditing away, you have to focus on firstly, whether this or that adds up, and secondly on checking whether the particular system is working' (Russell).

These basic tasks (e.g. trial balancing) do not require a great deal of critical reasoning in judgement and decision making processes and are generally disliked by the auditors. Ann shared her attitudes towards the audit process-related 'complications' experienced at the junior level.

'I think that intelligent human beings do not want to tick boxes and you do not want to be told to do, for example, twenty pages of the audit programme...you may not have even seen certain sections before, e.g. foreign currencies. I personally hate audit work for its long spells, but I suppose it is not fair' (Ann).

In short, the auditor in the first years of employment goes through the learning processes in the audit firm, gradually assuming greater responsibilities in terms of the level of complexity of information to be processed and interpreted. This process simultaneously involves incremental stages in status and satisfaction.

7.3.2 The use of symbolic language

The usage of appropriate language has many meanings in the 'realm of the real' of the audit practice. Language is understood as deeply constitutive of reality, not simply as a technical device for establishing the meanings of practice. Language brings understanding of the 'making' of the work in the interpretations of it (Riessman, 1993, p. 4). The auditor on the job allows for an affect in the language to describe the rationale of decision making processes. This signals an important layer of meaning that the auditor attaches to his/her work. The interviewees often referred to the process of 'getting a feel for the numbers' implying the need for their subjective and critical reasoning in judgements related to the client's operations. For example, Ann referred to such a process, describing the revision of standard hours for the audit testing in the audit programme.

'Every client is different, with different systems and records, so the audit requirements are different for each client. The idea is not rigid, nothing like 'you do this and that, so if you got this and that, then you have to do that as well'. Instead, you have to be there in understanding the client and to get a feeling for the numbers...then you know how to approach the audit programme, and whether to increase the standard' (Ann).

Pentland (1993) related the use of emotional language to a discourse of 'getting comfortable with the numbers' implying that objectively unaudited statements may be risky or uncertain, but subjectively, they make the auditor feel uncomfortable. Some auditors stressed the importance of comfort in the completion of the audit process. For those individuals a questioning process was linked to the ways in which the audit work was accomplished; e.g. 'do you have adequate coverage in the sales to be comfortable?'. Sarah relied on a feeling of comfort on the job.

'When you actually get into the details of the task, you are relying on them out of the comfort of your own understanding. If you understand the client properly, in particular its businesses, systems and approaches to management control, hopefully you will get most answers out of your planning and review work...And you should not walk away from anything you feel uncomfortable about' (Sarah).

From the perspective of audit judgement and decision making the use of affect in language raises the question of what is the role of emotion in the formation of the interpretations about the client and in arriving at the final conclusions on audit; that is, in forming an opinion. The language of affect suggests that the audit process is more descriptive of a 'gut feeling' than of a rational thought. Andrew explained the need for affective judgements in understanding of the client, he referred to the expression of 'gut feeling'.

'Whilst dealing with the client and reviewing the material you have to get business understanding, you can then feel for places, what is going on...you are aware of a 'gut feeling'. This is valuable in audit. From time to time you can get a cosy feeling that it [the client's] is very well run business and then you get to places and find things you are uncomfortable with' (Andrew).

The primacy of a 'gut feeling' for the auditor over the rationale of formal procedures in the audit planning process was found in Humphrey et al. (1993). Pentland (1993) found the importance of 'gut feeling' throughout the entire audit process. Hence, the prevalence of emotional language in the context of audit work seems to confirm the primacy of intuition over the usage of rational procedures. It could be argued that particularly in the group of 'big-

pictured', auditors tend to trust the affective side of their judgements linked to intuition and the attitude of professional scepticism.

Czarniawska-Joerges (1993) argues that individuals construct organisational life linguistically through the use of symbolic language illustrated by the application of labels, metaphors and platitudes (p. 19). These assist in creating a reality of belonging; that is, of being in the profession. Labels assist auditors with classifications of what things are, e.g. 'risk management'. Neil explained judgement in the context of new audit methodologies where the label of 'risk management' becomes a part of a symbolic jargon.

'We have new audit methodologies. Risk management is now a prime focus determining our [audit] work and is constant in our professional judgement' (Neil).

Metaphors create images and compress concepts in audit practice. The interviewees referred for instance to 'spray and pray audit testing' to describe risk-based audit methodologies or to 'mind set as against tool set' to emphasise the importance of independent thinking. Platitudes explain conventions of what is normal in audit, for instance the auditor's 'feel of comfort'. Sarah explained that in the environment where 'everybody relies on somebody's else work' auditors more compliant with structures (with structured methodologies) gain 'comfort' from regulation through legitimisation processes of the liability status of the auditor. The prevalence of symbolic language, rich in a professional jargon, in the language of auditors lends the appearance of infallibility in terms of a professional ideology of structure and demonstrates auditors' belonging to the exclusive group; that is, to the auditing profession.

The concept dependence of social phenomenon associated with employees' emotions on the job implies that what it constitutes in the work place depends on what it means to practitioners (Winch, 1958). The role of affect in audit judgement and the use of emotional language implies that what affect is in the audit process depends on how auditors perceive and interpret it and what it means to them. In turn, what affect in judgement means to auditors is played out in their practical knowledge of constitutive rules and procedures; this specialised knowledge governs how this affective side is gained or realised in judgement processes. What affect in judgement means to the auditors could be illustrated by the dynamics of judgement and structure metaphors. The auditing practice conceptualised in the dynamics of hermeneutics allows the depiction of interactions and tensions between these metaphors.

7.3.3 Hermeneutic context: Dynamics between judgement and structure metaphors

Auditing practice in this study is approached in terms of the hermeneutics of action; that is, the auditor on the job interprets the evidence of the client's operations embedded in the wider socio-organisational context. By doing so, the auditor produces assurance to the public that these interpretations provide a '*true and fair view*' of the client's affairs, that is they reflect the truth about the company and its underlying reality. In that way, by communicating the company's reality, the auditor constructs 'reality' to the public. The auditors' hermeneutic performance can be illustrated by their overall interpretations of the K plc case. On the whole, the interviewees had different ideas associated with the client's case material and the purpose of the research design.

Some auditors thought the case study was about conventional audit practice; that is, the study about the assessment of the risk and materiality. This can be illustrated by Russell and Stephen's examples.

'I suppose that the K's case is about assessing the risk associated with the audit testing, trying to work out a chance of material error and subsequently to determine what kind of work we should be doing...and what an impact the identified problem area has on the rest of the audit' (Russell).

'I think it [the study] is about an impact of the identified risk on thought processes with the view of this particular client [K plc]. The perceptions that the case creates is that the client is dodgy. It may not be dodgy, it may be just a one particular area highlighted' (Stephen).

Andrew believed that the case study was designed to assess an overall performance of the audit staff.

'I suppose the case is about trying to understand or determine how different levels of the staff would approach the problems and consider its various pieces and actually to deal with them' (Andrew).

Similarly, Sarah thought that the case was about an assessment of the auditors' performance, however she perceived the performance being embedded within a particular context of structural and organisational change.

'The main thing is probably associated with an approach to the audit in a period of change – with regard to the system and an introduction of new auditors' (Sarah).

Ernie and Ann interpreted the design of the case in a very specific context of the apparent independence issue.

'I guess the study is about how the auditor would react to circumstances that potentially create the conflict between the level of the audit risk he/she is willing to take and the level of fees...and whether or not to hold on to the K plc client (Ernie).

'I thought the case is about how you as a professional manage to do an audit and yet trying to get some more work for the firm. I thought immediately about the commercial awareness' (Ann).

Justin understood the case study through the prism of the assessment of the auditor's thought processes.

'I thought the case is about trying to understand thought processes that we as auditors go through in an acceptance of the client, at the planning stages of the audit, and then, in reactions to the circumstances that happened once you have taken on the client...in a modification of your approach and your responses towards it' (Justin).

Hence, majority of auditors recognised that the case was about the assessment of their judgmental performance on audit, however, they had different interpretations and understandings with regard to the context of the case study.

The client's accounts, apart from reporting the facts of economic activity, are the product of institutional dynamics and political interests, that is somewhat based on arbitrary classifications within the framework of national law (Hopwood and Miller, 1996). This process relates to the notion of operational independence. The operational side of independence is associated with the auditor's freedom and capacity to understand and interpret the 'economic text' narrated in the client's financial statements, enabling independent judgement and activating understanding of the client's context. The auditor needs to be aware of himself/herself, especially the capacity for critical and subjective reasoning in the context of operational audit approaches.

'You have to know when to sit back and to value your personal judgement, because you may take it for granted, because it is a part of you and you use judgement in so many ways all the time' (Sarah).

The auditors recognised the role of their personal understanding and intuition beyond technical parameters, as providing real guidance throughout the audit process.

'I tend to rely on my own intuition once I get the client, I decide how much work I need to do. You obviously have your technical guidance for a base on whichever methodology you are operating under...and you need to fulfil those, but you also need to maintain a degree of awareness on an on-going basis to be able to adopt the audit approach accordingly. Whether you formally modify the approach or whether your instincts are telling you that you need to do a bit more work here or there, we [auditors] need to actually understand what is going on. I think the real guidance in risk assessment through the audit is to always understand what has happened' (Justin).

'I think that audit is not about structure. As long as the work gets done and as long as at the end of the day we [auditors] are happy with the figures that sit in the accounts and understand them, how you get there is not terribly important. Understanding is good to help you to see details. I had to learn to step back' (Stephan).

Ann stressed the importance of client's appreciation and understanding of its business risks. She favoured the conceptual approach to audit which requires an understanding of the client's strategies, in other words she recognised a primacy of the conceptual approach over the 'spray and pray' audit testing (i.e. long spells of work in the context of 'risk-based' auditing).

'I have an assessment in my own mind about the company itself and numbers. I think there is an element of creativeness there of how it all would fit together' (Ann).

Similarly, Andrew emphasised the importance of individual thinking and a definition of alternative approaches in the process of revising prior year audit material.

'I am comfortable with different types of tasks which require thinking, like how to get from A to B; that is, how to manage a particular process and looking at the operations afresh rather than thinking 'I have to do twenty tasks to get there'. I prefer to do things that are challenging and from different perspectives, rather than just looking at all sorts of things we did in the previous year. I like challenge, not following what had been done before and accepting it. A good thing is to be open' (Andrew).

Ernie pointed out that identification of the client's key risks and their levels are already judgmental and subjective processes themselves despite the fact that standard parameters for the level of reasonableness are provided by the audit firm. There is a need to assure that risk has been reduced by audit work to a '*reasonable level*'. He mentioned fraud as an example.

'You know we [auditors] are not tasked with finding fraud. But obviously when there is a fraud which materially affects financial statements, then that makes us look bad. That is within our

remit that we have to be aware of fraud. It is not within our responsibilities to play systems to detect those frauds, you know, but at the same time you have to be aware that there is such risk and we have to mitigate such risk' (Ernie).

The processes of interpretations of the client's operations are recognised as being linked to a notion of professional scepticism.

'Understanding the client must be related to professional scepticism; the ability to actually step back from the work and to think about things...I think personally that this is really where my awareness comes from, through common sense and use of my brain...Professional scepticism is very much trying to work out what kind of people are there, what kind of explanations you were given. You may reflect upon those and you may then decide that it was not right after all. I think, it is a process of trying to use your own knowledge, trying to work out whether things are feasible' (Russell).

Neil pointed out that more subjective judgement aided by cumulative knowledge and experience implies in practice more efficient reviews and more appropriate selection of areas of focus on the audit. He pointed out the need for balance between judgement and operational audit methodologies.

'If you focus really on audit methodology, you are missing something of why you are there and what to do. It is all about the client. All about it. You have to be aware of each issue or error which comes up in the context of the layout. Whereas theory (i.e. procedures) will tell you how to deal with that, it is important that you focus on the actual set of accounts and make decisions on that basis. Methodology is there to guide you, but not exactly to explain how you should be doing it' (Neil).

Justin was aware of the need for existence of structure balanced by intuitive thinking. He argued that structure is present in audit because the auditor has to be covered with regard to the auditor's duties and responsibilities; in such ways the legitimacy processes work in the profession. Similarly, Justin pointed out that structure should be treated as guidance on the audit.

'There has been a lot of literature recently about what types of master techniques there are, how they tie with a certain materiality threshold, and what really auditors should be doing (i.e. to go through the various checklists to make sure that one can cover himself/herself). People's instincts prompt you to hold on to something and to be guided throughout the audit process. Having a checklist you can go through, a test that is very clear about what steps you have to undertake – this is what people tend to prefer. My personal preference is to be able to stand back

and understand what risks are and adopt approaches accordingly. But whilst relying on your judgements you can get things wrong. That is where you need the professional risk management structure to which you can refer to make sure that you have gone through the right hoops. I think that the trick is to teach the staff to use the structure as a guideline to make sure that one is not going away too far off the track. At the same time, it is important to develop intuition, to challenge auditors to use their brains, rather than just going through 'I have done this and that, then it must be right' logic. The auditor has to accept the need to be able to understand the whole picture. And in the end we [auditors] have to have these structures, because you can not rely on having a team of individuals with such a fine judgement that work in every situation, 365 days a year, when you are tired or something is distracting you. You can easily miss things. You have to have certain structure to revert back to, to guide you, but it does have drawbacks. In terms of experience, I realised the need to have structure in place and realised both its strengths and limitations. So I know when I can take in a situation and devise an intelligent approach, more than just saying what of standards and audit techniques we can apply...and also you need to make sure that you are covered' (Justin).

Andrew argued that the structure, if properly understood, exists for the benefit of the auditor.

'There is the fraud risk assessment tool and we use that through the audit. It consists of number of lengthy questions. That helps to point out factors that would indicate higher risks. I mentioned this fraud tool, because I know that it helps people with less understanding or experience' (Andrew).

Neil expanded on the role of structure (importance of working papers) in the legitimacy processes regarding liability status in auditing.

'What is important is to make sure that from the management point of view you are not exposing the firm. What is important then is the audit file; if you exercise audit judgement the file has to contain the reasons of 'this is why and what I have done'. Before the report is signed off, somebody can review that; it takes the weight away from you by the process of checking and approving the decisions you were taking' (Neil).

Russell was aware of the existence of both structure and critical reasoning on the job. He argued that these are built into daily audit work.

'You tend to be busy, you need to make sure that you do work, that you do not step back. But on the whole what you do is trying to get explanations for things. I think, therefore, that scepticism is somewhat built into day to day operations. I do not think that people spend half a day auditing and the other half being subjective. I think, it is all part of the same work. You need to have structure though to make sure that you do all necessary work, because if you are completely

unstructured you may miss something, some areas of work. I think, you have to have flexibility and you need to use your own judgement. It is good to have a mix' (Russell).

Sarah argued that despite the methodology used on the audit there is always scope for use of individual judgement.

'I think that there is still scope within the structured methodologies to use judgement. Whether there is enough judgement depends on the individual. If you have an individual who just wants the job to be done, he/she may use a structured approach as an excuse for not using individual judgement. You can use your judgement but get things wrong...there must be a scope to use sufficient judgement' (Sarah).

Neil pointed at the difficulties with regard to the operationalisation of balance between structure and individual judgement within the dynamics of the audit team. From the position of a team manager he stressed a need to trust in people, so as to facilitate such balance.

'I do not think you can ever teach people how to deal with the individual client's situation. You have to have laid down a set of rules, a standard situation of how to deal with xyz. Also you have to make sure that if certain steps are mandatory, you give freedom to people who are taking decisions to be able to let them to do that. You have to very much trust your people as long as they are sensible, that is as far as methodology has to be taken into account' (Neil).

In short, the auditors were aware of existing tensions between judgement and structure metaphors at different stages of the audit process. Insights from the auditors' stories confirmed the existence of different attitudes to these tensions in the audit process corresponding with patterns in the case study experiment. The interviewees valued their judgement, as a personal asset enabling creative thinking, intuition and professional scepticism; that is, the hermeneutic dimension of the auditor on-the-job has been confirmed. On the whole, structure was regarded as existing for the benefit of legitimisation processes within the auditing profession; the interviewees often related to turbulent environments, expectations of the public and referred to recent court cases when the firms were sued. Further, Neil and Justin emphasised that the existence of structure needs to be complemented by an understanding of its role as no more than a guideline on audit. Some auditors recognised the need for the presence of both structure and judgement in the operational internal procedures. Hence, it could be argued that there is a hidden agenda within the audit firm regarding the balance of these metaphors. The auditor needs to learn the 'craft' to apply both, so as to enable seeing the 'big-picture' orientation of the client's affairs within structured inquiry of operational approaches.

The internal culture within the firm was in general perceived as facilitative and promoting the standard behaviour and application of professional jargon which auditors often linked to emotions in judgement and decision making processes. The story of the 'realm of the real' pointed towards the role of the firm in the processes of predisposing individuals to the audit work and confirmed that audit judgement processes are impeded by the structure of the operational audit approaches.

7.3.4 Predisposition to audit: the role of the firm

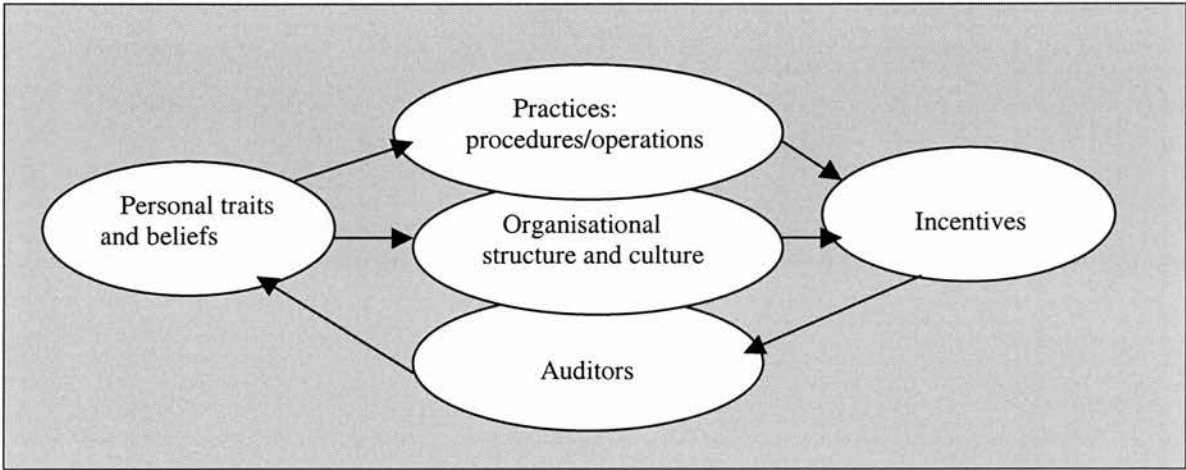
One of the important ways to gain an understanding of organisational change is to investigate its learning processes. Literature on organisational learning argues that organisational routines act as the memory of the organisation, i.e. the auditing firm. In other words, the ways of doing things in an organisation, successful patterns of behaviour and standard operating procedures are stored in the memory of the organisation in the form of these organisational routines (Winter, 1986), i.e. benchmark behaviours and recognised performance are expressed through evaluation processes of mentoring and internal counselling sessions.

Structures create incentives and mediate the auditor's awareness to act and behave in particular ways. Individual awareness on the other hand assists in the (re)creating of practices and accordingly structures. Understanding how the personal identity and values of the audit staff have been constructed is therefore vital in unveiling what the auditing firm says about itself and about the profession. The dynamics of individual awareness and learning processes within the audit firm can be illustrated in form of the personal traits – incentives diagram (Diagram 7.1). Individuals bring a personal dimension to the workplace that affects practices and structures. Structures and procedures, in turn, create incentives affecting individuals and predispose them to audit.

This individual awareness of the auditor is embedded in wider social contexts. The audit firm is an integral part of wider systems interacting with its environment and shaping the learning processes that produce action; that is, audit services.

'There are professional constraints, sort of wider reality constraints that are always upon you; there is time pressure from the firm to get something issued, there is pressure from the public to announce the results' (Justin).

Exhibit 7.1
Individual awareness in the audit firm: Personal traits and values versus incentives



To understand how the processes of predisposition to audit function, it is important to find out how the auditing firms’ institutional structures and internal procedures are represented and operated. Self-assessment questionnaires and formal monitoring systems are now common tools to involve staff in analysing their performance in the context of the existing structural processes at the formal staff evaluation meetings.

Neil recognised the need for awareness of benchmark behaviour in the firm and the ways the auditor is trained to think. He emphasised the role of the performance appraisal system as his reference for objective behaviour. He saw the role of award (recognition), visible in such a system, as an incentive for the auditor to behave in a certain way.

‘The evaluation process is a two-way process: my self-assessment combined with my appraiser’s assessment and followed by a joint discussion. The rules governing my behaviour are shaped by the culture of the firm and this performance appraisal system. I learnt what behaviour is rewarded’ (Neil).

In a similar way, Sarah understood the need for knowledge acquired in the firm about the ‘rules’ governing her behaviour. She could gain insights to such rules from independence rules issued to all staff. Ann stressed that she learnt how important it is to be seen in the firm to be performing effectively.

'The evaluation is vital in gauging how my performance is perceived. I mean, comparing my self-assessment to an objective view of the firm [benchmark behaviour]. It makes me aware of the need to be seen to be performing an effective audit' (Ann).

Evaluating process is regarded as a comparative exercise of self-assessment with myth categories of 'ideal of service' propagated by the firm, i.e. an objective view of what performance should be according to audit manual. John argued that in a sense, the firm shapes its staff, as the individual discerns how he/she should perform on audit to remain in the firm, and subsequently to remain in the practice.

'People are different, but we [auditors] are thought to think in a similar way in the firm and even the members of the institute are thought similar...If something happens there are certain facts you must go through and certain things to do. We are thought in terms of the end of the product, and that is risk' (John).

Ernie envisaged the evaluation process as a 'box-ticking' exercise. He did not value this process in general, unless the evaluator was willing to help him.

'The evaluations are almost a box ticking exercises. You know within yourself how good and how bad your performance has been. Some partners use it as a motivational tool. I personally value the meeting only if I can feel that the evaluator is listening and interested in helping me to develop, instead of filling the right form again' (Ernie).

Ernie further shared his experience with bureaucratic controls in the firm.

'A certain set of authority limits a close day to day involvement with the partners. You want to learn but you meet obstacles...I gained my knowledge at times by trial and error due to my personality, i.e. 'do first and consult later'' (Ernie).

In general, auditors are evaluated after each assignment; that is, on average six times a year at the senior/managerial levels. Ann and Ernie, however, pointed out that their evaluation happens formally twice a year and after any significant engagement. In addition, the auditors have formally an annual counselling session. The evaluation process is largely based on the Staff Evaluation Form (SEF). The sections under which the auditor is evaluated in order of appearance in the SEF include: 'Exceeding client's expectations', 'Developing our people', 'Ensuring effectiveness', 'Managing risk', 'Using technology effectively', 'Communicating continuously' and 'Evaluating performance'. Within each section the auditor is assessed twice – by the evaluator and by the auditor himself/herself – with regard to objectives and targets, that is

whether they were met, exceeded expectations or not realised at all. On that basis the capabilities needed to meet unrealised objectives and actions required to achieve those are identified. In the last section of the SEF the auditor is assessed in a narrative form with regard to an overview of recent performance and the directions for development on future engagements with clients are identified.

Closer examination of the auditors' perceptions regarding the sections of a Staff Evaluation Forms reveals that, on the whole, individuality is promoted in the firm culture, in particular its behavioural aspects. The assessment form is very much client orientated; that is, awareness of the client's needs seem to be prioritised in the individual performance. Further, both audit firms encourage NAS opportunities' awareness.

'It seems to be in the public interest our tendering for the work. We may be less harsh on the audit since we benefit from knowledge spillovers. We have to make sure that audit is done correctly, but if there is additional work that it is fair enough – we will be able to tender for it' (Stephen).

'I think it becomes a common scenario for a multidisciplinary firm that you have a certain division to integrate non-audit services. As you progress within the firm, your focus becomes more skewed towards that. There is a specific training to enable you to be more alert to other services opportunities. It is a reflection on the state of my career. In the UK the sensitivity area is the level of non-audit fees disclosed in the firm's financial statements, but it has to be something striking to be a real independence issue' (Justin).

The auditors argued that, on the whole, they are encouraged to seek for other opportunities, i.e. for consulting, but they still have to concentrate on the audit job. Stephen linked NAS awareness to financial incentives.

'As you look at NAS in a certain way, that is one firm is maximising income, it is not necessarily by asking the client for £ 1k extra for audit, if it can get much more from the consulting. Auditing has its own goals and to throw away money to another department within the firm and get fee under the table – it is hard to take for lots of people. But it does not bother me, all I worry is to be paid by the end of the week' (Stephen).

Hence, in terms of value for money, the client is perceived as not gaining much value from the audit and being at the same time obliged to pay for it. Regarding management consulting, the benefits from their provisions occur in more tangible ways. Stephan argued that this is why the client is always willing to pay more for consultancy. Sarah stressed that judgement is valued

more with regard to behaviour in terms of dealing with the client, i.e. winning new tenders (i.e. NAS orientation).

‘You bring another asset in terms of the client mix and its industries, you are encouraged to judge what the fees are likely to be in terms of the recovery of risks and whether you can do it profitably or not’ (Sarah).

The interviewees recognised tensions associated with the provisions of non-audit services.

‘There can be tensions because there is a possibility that the audit becomes narrower...because of the existing expectation gap whilst the consultants focus on different areas. The client expects that while using the same firm that you know all about other services whereas the consultants will be covering other areas. That can create tensions of areas of interest between the firm and the client, also between the consultants and auditors. It is important that consultants do the job well if the client is significant for audit. There is obviously a triangle of tensions’ (Neil).

Auditors shared the view that personal professional attributes are often highlighted in their assessments, such as communication skills, attitudes of energy and leadership, thinking in terms of ‘watch your mindset not your tool set’. With regard to job-oriented attributes the auditors emphasised job management and people development, i.e. organisation and project management, as frequently quoted in their assessment forms.

The sources of auditors’ knowledge revealed some insights into the learning processes within the organisation and in the auditing profession. Most of the interviewees identified personal individual experience as the key source of knowledge before any courses, workshops or technical materials. They emphasised the importance of the experience gained from particular engagements (Ernie, John), learning from peers (Ann, Stephen, Russell), from errors and fraud cases (Sarah, Justin) and from embeddedness with their clients (i.e. accumulated client’s knowledge) (Neil, Andrew). Ernie shared how his personal experience with a fraudulent client tightened his awareness of fraud.

‘I have been involved in an audit where there was a fraud, it tightens your awareness. You have to be aware of the pressures on management, the pressures on the individual when this kind of thing happens. There is obviously awareness of the need to maintain earnings, the companies with aggressive management will potentially look to that. So you have to be more vigilant’ (Ernie).

Russell shared how he learns while engaging with the clients.

'You learn through working with the clients all year round, with different industries. Clients' relations...once I know them well, I am less sceptical, because I have seen things and I know people, I know individuals. With those clients who are new to me I am more sceptical because I am trying to work out and judge in my own mind how well-run they are, how honest they are...It is like trying to use your knowledge of whether things are feasible. If you have a judgmental issue, you can look back at your cumulative knowledge and work out things from your past experiences' (Russell).

Stephen, Sarah and Andrew pointed at the importance of embeddedness with the clients.

'I have my old clients, so I know them well, audit becomes more of a confirmation exercise and it is easier to see the 'big-picture' and the context of things. There is a lot of background knowledge about the client within the audit team, and if you can use it then the client will appreciate it. You can brief the client for thirty minutes or so and provide them with your basic knowledge...it will impress the client' (Stephen).

'To understand your client means regular contacts with the client, meetings, revision of the information they produce for their internal purposes, public information, i.e. chairman statements and management accounts, information they are producing, kinds of indicators they are using for the business. I mean, you really get to know them. In the 80s and 90s audit firms went through a competitive arena which discounted audit and started to devalue it. We brought these pressures to ourselves as a profession, and now, we have to live with the consequences. I think that when the firm has a good audit relationship, the client sees it as more than just a statutory audit. You are treated as a key person, as a consultant' (Sarah).

'Lots of NAS assignments are actually initiated by the client who comes to us, because of our skill set and our understanding of their businesses, and they would value our services from previous years' (Andrew).

The majority of interviewees regarded continuous self-assessment as a very important source of knowledge. Other sources of knowledge mentioned included technical training (i.e. internal and external courses) and self-training (i.e. electronic research material, technical material including standards and journals, accounting databases). Auditors, on the whole, were aware that they are expected to act as high status professionals. They acquire such tacit knowledge during the socialisation processes (i.e. the structured training programme, periodical reviews, seminars etc). Regarding the uniformity of performance, they learn a hidden agenda of how to be a professional within the framework of the firm and the profession. This agenda includes the role

of language, i.e. professional jargon, clothing and *in situ* behaviour. These are means in which the audit firm expresses its position and strength. Jargon is believed to unify members of the profession as an exclusive group of professionals at the macro scale as well as a co-ordinated audit team at the micro scale. Further, language differentiates the profession from other professions. A suitable and smart 'outlook' somewhat reflects upon the credibility of the tasks of the individual auditor enabling him/her to 'be seen as professional'. Further, the look provides certain assurance to the public with regard to the expertise of the auditor. Overall, learnt behaviour confirms professional unity and legitimacy regarding the liability status of the auditor in the wider social context.

In summary, structure creates incentives so as to enable the predisposition to audit work. On the other hand, the auditors' identity, i.e. personal traits and beliefs affect their operational awareness, and thus, affect the ways in which they respond to the structures within the firm, and accordingly how structures develop.

7.3.5 Organisational change: From old to new audit methodologies

The perceptions on the dynamics of the learning processes within the audit firm allowed access to the auditors' concerns associated with structural and organisational change, in particular, the introduction of new audit methodologies. Sarah provided some insights into this organisational change associated with the merging process and the introduction of the new methodologies.

'We have had an incredibly structured approach. We, as a firm, are now taking a very different approach. If we take it to full extreme, it would mean being already involved with the client fully at the early stages of our audit process. That would involve understanding of what clients are doing and working with them, not necessarily at the year-end looking at all stored data. I think, it will be a period of time before we get an ideal position between the two methodologies. If it is done well [the merging process], the two methodologies will be married together [from two merging firms] and will evolve towards more thought processes' (Sarah).

Justin shared his experience with old methodologies and with the introduction of the new approaches.

'When I started training in London with the firm, we had a very substantive approach. I did a law degree and did not really follow the statistical approach of 'number of items' or 'within the population of balance sheet... therefore if we test sixty items and if we are going to tick them with the invoice then we have covered our backs'. This is what we were taught, that approach was very much based on the fact that you had to make sure that your working papers were sufficient, and that you were able to justify what you have done and what you have not done.

And the most frustrating thing was to reveal the working papers because people questioned what you had done. For instance, there were tests for analytical review purposes where people lined up two sets of numbers subtracting the difference, and if it was below a certain amount you did not have to look at, rather than to understand what it should be below a certain amount and above it. I think we moved towards this approach in a way of saying 'well, lets understand what the risks are within the business, lets understand the controls placed over those risks and lets make sure that we capture all those controls and that they are efficiently operating to mitigate the risk'. With regard to change in our methodology, that was revealed in our firm over the last eighteen months, we have to strive towards understanding of what the businesses are about, to understand the risks that businesses face, and one of key things that you would be asked to do is to understand what fraud risks are within that business' (Justin).

The firms are currently in the process of introducing the new strategic approaches to audit. The steps of these new methodologies include: (1) assessment of risks facing the entity and its operational environment, (2) identification and testing of controls over those risks, (3) the assessments of residual audit risk based on steps (1) and (2), and (4) a risk reduction plan in conjunction with the client (where necessary). Here are the narratives of how the auditors perceived the nature of these new methodologies.

'Our new audit methodology focuses on the identification and mitigation of key business risks. Audit risk is focused on testing the client risk controls and detailed analytical review. Aims [of these methodologies] are to reduce litigation risk and increase client's value added' (John).

'Methodology is continually changing. The current one has been heavily shaped by risk management and the drive to increase/maintain recoveries in the face of fee pressure, i.e. minimum documentation, and work reviewed only once, and by discussion, use of specialists at every possibility' (Neil).

'New methodology characterises basically a minimum documentation on the audit file. The work documented must allow re-performance. Reviews are done by interviews' (Sarah).

Most interviewees perceived the need to focus on business risks' areas rather than simply on financial statements risk as the most important difference in new approaches in comparison to the old operational methodologies. The auditors emphasised the need for the use of specialists in order to manage the key risks and to improve client's services, continuous debriefing (i.e. continuous assessment, more time spent with an audit team), and a minimum documentation on a file (e.g. client's ledgers) as the characteristics of the new operational approaches.

'The new methodology focuses on understanding the specific risks within each client rather than 'spray and pray' audit testing. The approach - when I have started in the firm - was related to the numbers and checking whether they were OK. We tended to over audit, we did a lot of purposeless testing. For instance, we did not take for credit that a number was a computer-generated number' (Ann).

'The differences include more control testing work pre year end, less post year end substantive audit work and more focus on value added' (Ernie).

The auditors in particular perceived the differences between old and new methodologies in the area of execution of judgement. They argued that judgement used to be applied on financial reporting issues, accounting estimates and in ensuring the adequate scope of the substantive testing, in the context of 'risk-based' methodologies.

'Judgement in previous methodologies was limited to the adequacy of statistical sampling, materiality issues, financial reporting, and the application of the local GAAP' (Ann).

There were a few auditors, however, who argued that judgement did not change in the context of the audit process, framed by the new methods. Sarah, for instance, argued that professional judgement is always present in audit, despite the operational approaches in use. She argued that nowadays individuals are more risk aware, and consequently to use their judgements more.

Judgement within the framework of the new methodologies was perceived on the whole as broader. The auditors argued that they are encouraged to see a 'bigger picture' within the framework of the new methodologies. For instance, the fraud evaluation questionnaire recently became a mandatory tool in audit.

'In our audit approach to complete the fraud evaluation questionnaire is mandatory, it was not previously. Normally, the procurement cycle is a classic example of fraud and we have developed specific procedures to look at fraud, at those areas of the companies' accounts related to long term contracts and subcontracts. I think that the firm is aware of where potential litigation emerges from, and fraud is obviously one of the key areas in that respect that we have to be aware of. It is probably at the very beginning of the engagement that we consider fraud risks, i.e. potential transactions, motives of the management, opportunities. If we identify fraud risk then we know how to focus our work, so as to cover and mitigate that risk' (John).

It is, however, arguable whether fraud awareness will not become another form of structure prescribed on audit or a means of legitimization of litigation mediating genuine understanding of

the client's specific problems. Further, regardless of the methodology in operation, the auditors perceived the existence of the expectation gap as unjust.

'It is obviously not fair to hold the auditor to be responsible for finding and reporting fraud, in particular if you have an engagement collusion. Further, it is unfair to hold the auditor to be responsible for the full extent of the loss, which in most cases is unrelated to audit fee, and to all the work involved' (Sarah).

'As the auditor you do not have to think about fraud straight away, because it is not what is right for us to do, to go out and look for fraud. I think if you went out looking for material intentional misstatements you would wipe out at the beginning few clients. However, if there are indications of fraud, you have to take more care' (Ann).

Due to the expectation gap auditors became aware of the need to respond in the audit more attentively to fraud risks.

'I think there is a changing perception within the business community and in society in general, of what auditors do and what their roles are. There is a perception in a wider world that auditors should pick up on fraud whereas from within the profession there is a very defensive attitude that we are 'watchdogs' not 'bloodhounds' to which auditors cling. It is important for auditors to protect themselves, to limit their liability in terms of what they promise to be able to find. If you ask the auditor, he/she will say 'we can not be responsible to pick up on everything', and/or 'we would *hope* to pick up on most material fraud'. It is obviously a conflict of interests. I think we auditors have to strive towards understanding of fraud risks within the client's business, and to make sure that audit work is designed in such a way to target those risks' (Justin).

'Although there is no legal responsibility for fraud, the auditor must be aware of it. If fraud happens, the auditor will be asked a lot of questions. If you are signing the work, people expect that there is no fraud in it in one hundred percent, but it is not a truth. From the risk management point of view, you must be sure that there are no holes in work you have done' (Neil).

Independent judgement is required to assess whether risk associated with the key business risks has been reduced by audit work to an acceptable level. The processes of identification of key business risks are also regarded as judgmental. Judgement, on the whole, is regarded as being focused on the client's appreciation and management of risks (including fraud risk). Auditors agreed that judgement is more subjective in its nature while operationalised within the framework of the new methodologies.

'Judgement is more subjective, there are fewer standard parameters in establishing a 'reasonable level' and less statistical sampling' (Justin).

'The nature of judgement is subjective because it depends upon your assessment of which risks are significant to a business, and on your understanding of the client's strategy. There is more efficient review and selection of areas of focus (although both are aided by your cumulative knowledge and experience)' (Neil).

The interviewees expressed some anxiety associated with these organisational and structural changes. They perceived the need to adapt to new approaches; that is, they need to be retrained to think in new ways, and they need to regain the confidence of comfort while operationalising an audit. Sarah shared some insights associated with the administrative problem, and argued that new methodologies in operation are improved and tailored versions of the old ones.

'All of us [auditors] were put to courses in July and August last year, and we are trying very hard with these changes. It was one of the biggest training courses running anywhere in the world for a professional services firm, it involved over forty thousand people in three months fed through this training on the individual audit programme. After six months it was interesting to see whether actually anything changed and *in fact what we were doing was just tailoring to the system and to paper work*' (Sarah).

The auditors shared some uncertainty with regard to change, and on the whole they perceived themselves as vulnerable in the context of a structural transition. In particular, the auditors expressed uncertainty associated with legitimacy processes while adopting their subjective judgements in the new context. Ernie argued that increased subjectivity of judgement requires greater consultation with others and with specialists to keep up with business sophistication. The interviewees pointed out that within wider scope judgements, they need to be more alert during the audit, and they emphasised an increase in the client's sophistication.

In short, an operational independence threat seems to be less prominent in the context of the new audit methodologies. That is, a compliance dilemma between the internal policies and procedures of the firm's conduct and the auditor's subjective judgements is less evident in this new context since the auditor is more aware of his/her capacity for critique and subjective reasoning. Hence, the proposition of structure 'binding' auditors' judgements (i.e. judgement being driven out by compliance mentality) seem less prominent in the context of the new audit methodologies. However, the problems associated with the new methodologies are related to legitimacy processes regarding the liability status of the auditor (i.e. the new audit methodologies are characterised by less working papers, more verbal evidence embedded in the

context of increasing sophistication of clients). The concern is now more to do with the process being too judgmental for the audit reliance being placed upon it (Hatherly, 1999). Further, there is some indication that new methodologies become a tailored version of old methodologies; that is, 're-packed' and 're-jargoned' in the structure of step by step audit operational approaches. Whether the regulator will conduce the new methodologies back to the rule-form, and/or whether the new methodologies will become 'prescribed' in the 'risk-based' format, will become clear in time.

7.4 Learning styles of the auditor and judgement

The auditor's characteristics influence the exercise of judgement in response to the structure of the audit approaches (APB, 1996). The auditor's advance skills and inherited ways of being translate 'book learning' into effective execution on the job, i.e. the ability to apply the existing rules and frameworks to complex client's problems with more or less subjectivity. Each individual person has a particular way of perceiving the world and being in the world, hence, the learning processes of predisposition to audit and to the existing structures are adjusted according to personal beliefs and values. The attitude of subjectivity permits moving beyond the execution of task to solve the client's specific problems with the innate ability to anticipate unintended consequences and realities. The personality of the auditor and his/her expertise and experience are intertwined and interrelated in on-the-job judgement strategies.

What emerged from the questionnaire findings is the evidence that auditors respond to the particular circumstances of the client (K plc) in different ways parallel with their different responses to the structure of operational audit approaches; that is, conventional and 'big-pictured' auditors. The first group was not capable of seeing the reality of the client beyond the layout of risk-based auditing, and is non-transcending of the prescribed structure. The latter, was able to see the bigger picture of the client's affairs presented in the case material, and those auditors were able to transcend the structure of operational approaches in their judgement processes. This section expands on this categorisation, and presents how the interviewees perceived their personalities, and how this links with their judgement strategies and the treatment of structure in the audit process.

On the whole, the interviewees were open to talk about their personalities describing both the strengths and weaknesses of their personal traits and the influence of those traits on the practice of auditing. The majority of the interviewees perceived themselves as mostly analytical and structured thinkers.

‘Some people are more aggressive than others, some people are more comfortable with the set of rules, playing things by the book. I am somebody who operates by the book and I tend to be governed by rules and timetables, so there are always laid down procedures. It is more like applying rules to the client. If there is a problem, I think in structured ways of how did it arise, did it affect something else and what is its impact. So, unconsciously I am governed by a set of existing procedures. It happens at different stages; you are following the book to make sure that your planning is done properly, your team is briefed, set-up, then you can delegate details to the members of the team and you can focus on the results of the work they perform and on the client as well. In the end, you have to see what you are signing off – what is important is a client’s delivery, it is very much a risk management exercise...I am structured too, because I tend to be logical and mostly governed by rules’ (Neil).

‘I suppose I am analytical person, but I would like to think that I have some creative flair as well. I am number conscious, but there is an element of creativeness there. I am systematic but not rigid. I think that auditing on the whole is an analytical discipline, very hard thinking’ (Ann).

‘I think that in terms of approaching an audit I am structured, in terms of planning the audit in particular. You have to identify risks. If you pick up on something, you want to know what are the implications. For me, auditing is a quite rewarding discipline despite the image it has as being dull’ (Stephan).

Andrew and Stephan related their structured thinking to the ways the things are done in the firm.

‘I think, I am fairly structured. I tend to go through things in a logical manner and break things I am trying to do into pieces, and then deal with those. I think I am loyal to the firm – it is very much firm’s view, not my own, it is a part of this profession’ (Andrew).

‘I believe that I am analytical person...In the firm I have learnt to follow structures’ (Stephan).

Ernie and John perceived themselves as analytical thinkers and within the reality of the socialisation processes in the audit firm. They recognised the need to expand their ways of being.

‘I think that my natural inclination is to be more of an analytical thinker, but as you progress in the firm you have to be more creative, you have to see the angles. If you are not able to look at the ‘big picture’, the chances are that you are missing something or that you would get something in the wrong perspective. So it is almost that you teach yourself to be more creative. I had to do that. I still do that’ (Ernie).

'My experience led to a turning point when I realised a need to broaden thinking at all levels; that is, detail time on a structured basis and more time giving assistance to seniors, trying to get from them that particular awareness' (John).

Russell perceived himself as unstructured within the structured work, compliant on the whole with the layout of the audit process and within that framework aware of his judgmental qualities.

'The work that we do is quite structured but we [auditors] are encouraged to use our own interpretations, our own mind as we work. I think I am unstructured. You need the structure though to make sure that you do all required jobs, you have to follow it. As a manager, I review others' work from the field in terms of follow up; that is, whether it is a major issue to discuss with the partner or is it a minor issue, and can be dealt with at lower levels. Here, I rely on my judgement' (Russell).

Out of all interviewees, Justin and Sarah perceived themselves as creative and unstructured, 'big-pictured' thinkers.

'It is important for the auditor not to just accept everything he/she is told without thinking, as it would actually not make any sense. But it is also very easy for the client to convince the auditor that there is nothing unacceptable, and you have to have a strong questioning personality to go back and to say 'excuse me, I do not understand that, can you take me through it again'. You have to be sure. If you do not understand something, you have to make sure that you do. If you come up with misleading information then you have to inquire further. Understanding is good to help me to see details in the client's environment' (Sarah).

They both argued that they can be compliant with the structure on audit but only to a certain level.

'I find a balance between the structure of the audit process and my judgement as long as it seems like second nature. I think, I am naturally inquisitive. I am able to be structured, though reasonably because, if I like to know how to get from A to B, I sometimes go to C, depending on my thought processes at the time' (Sarah).

Justin expressed tolerance with structure and his willingness to be adaptive as long as he can balance his 'creative side'.

'I see myself as a creative thinker. In the audit practice, which is not the most creative of professions, I can be very creative. But if something comes up that requires step by step analysis,

then I am able to go through each of these steps and make sure that they are conformant and to analyse each individual element, then all the ingredients, and finally you make a judgement as to whether and what size effects audit pulls out. I think, I balance on the creative side and see widely' (Justin).

Sarah expanded on her attitudes towards the structure on audit.

'I feel constrained by the structure. I think if I was given a blank paper on audit I would be able to write more (possibly)' (Sarah).

Hence, the auditors perceived themselves differently with regard to operational audit methodologies, with the group of auditors compliant with the structure of operational approaches (i.e. who perceived themselves as structured and analytical thinkers) being predominant.

What further emerges from the auditors' discourses is the unconscious link made between ways of being on audit and their personal background and education. The majority of analytical thinkers (to the level they perceive themselves), those compliant with structure, did accountancy and statistics degrees at the university.

'I did an accountancy degree. I think, it is a rewarding discipline. So ten years of accounting after the university. I wish I did a different degree because in the firm there is a lot of us [auditors] who do not come from the accounting background' (John).

'I went to St Andrews to do statistics and some economics' (Ann).

'I did statistics in London. It was hard' (Stephan).

Andrew perceived his accountancy degree pragmatically, he believed it equipped him with specific skills and knowledge.

'I started off doing accountancy and business law, then just accountancy. I was not sure what I wanted to do at first, but I was always good with numbers, comfortable with numbers. I think it was quite a useful degree to do. I thought then that more general types of degrees, such as arts are not focused enough, and in the end you do not get a particularly specific skill set' (Andrew).

'Bigger-pictured' auditors came from various educational backgrounds. Russell who perceived himself as an unstructured thinker but compliant with structure did a law degree. Sarah and Justin did combined degrees.

'I did a degree in German and accountancy. I thought it was reasonable combination of maths and economics with practical implications, and literature helped too. Then I went to practice and did professional exams in London' (Sarah).

'There are certain interesting facts through tracks of my education. I came to Edinburgh to do an English degree. I think you probably cannot find an analytical approach basically through reading books. Then I switched to do a French degree, I wanted to learn another language. When you are learning a language, you approach it in an analytical way, but I did not have the self-discipline to sit down and go through the whole of grammar, and understand what it was all about. Then I went to France to learn to speak. Now, I am able to communicate very well in French, but I am aware of grammatical mistakes – it does not bother me. And I am still able to study literature in my free time – again my creative base...I went then to do two years LLB, where you change; it was a much more analytical process. I think that law can be very creative, but personally, for somebody who is an outsider in a discipline, the first thing to do was to understand the systems and that developed thought in an analytical form. If I put these two strands of my education, I can understand how I am operating in the professional terms. I am mostly creative in my thinking, but not systematic' (Justin).

Sarah and Justin (both 'big-pictured') shared the importance of professional experience in the formation of the ways they are on audit; that is, acquiring a sense of questioning and an attitude of professional scepticism.

'I believe, I am very assertive and intelligent on audit (and in private too). If I do not understand something, it does not worry me. I have been doing this for at least thirteen years, which makes a difference in comparison with those doing audit for two or three years. Some of the best training is learning from other people by 'did you consider this or that', a form of the apprenticeship in work practices' (Sarah).

'I remember one thing they used to say when I first joined the firm, it was a need to exercise professional cynicism. I do not think that I necessarily wanted it to come out in ways that it sometimes does; that is, too cynical. I try to balance between understanding the constraints within the client I am operating with, and telling myself a cynical attitude with regard to whether I understand what they are doing there, and I think, it does not do any harm. I am naturally a cynical person.' (Justin).

Further, Sarah and Justin perceived themselves as naturally inquisitive and self-confident individuals. Russell shared that he learned in the profession to be sceptical and how to control the level of scepticism.

'I can be sceptical. When you are planning to be a chartered accountant you are thought to be sceptical...I did an accountancy degree before. I learnt to be calculating too with regard to our [auditors'] responsibilities. Ultimately I have twenty clients, if I was to lose some of those clients, it would not be bad for me or for the firm. If we were to lose those clients, because we would be too sceptical or not trustworthy enough, it would not affect the firm or the profession so much. But if I had two clients... that case would be very different. There is a line, though, when you can not put more pressure on fees and work, because you have to do a certain amount of work and check whether the accounts are OK. You need to be aware of those things' (Russell).

Neil, Ernie and Russell argued that their sense of professional scepticism is very much related to family background as well as education.

'I think my family life influenced me as well as my education (I did accountancy and ICAS exams), definitely these two factors influenced how I behave and think. I believe my mother and my father are very much followers of rules and they never break any rules. So I tend to do the same. My mother is a teacher and my father a bank manager, we had to move often and be adaptive...I am not easy going and I do not trust immediately. I think it is partly because I have moved schools so often. When I made good friends, I had to go away and not to see them again. So, I had to learn to focus on myself first and then take other people as they come' (Neil).

'I come from a fairly working class background and potentially my attitude to risks - in particular with relation to fraud - is slightly fearful. I learnt to think that people were doing something illegal and making themselves richer out of this. I have not gone to that at the conscious level to analyse my motives, it is more unconscious thinking' (Ernie).

'My background thought me to be adaptive. I had to change schools, primary and secondary schools. We [the family] used to travel a lot. I learnt to be sceptical with new people, with new friends' (Russell).

Similarly, John and Andrew argued that their background influenced their thinking.

'As the profession, people feel they are being ethical. I think, I am friendly and outgoing, even open, but at the same time, I am sceptical. I do not trust people blindly, it may seem terrible, but I always question people. You learn it somehow, it is not easy' (John).

Ann shared that she found it difficult to acquire an attitude of professional scepticism.

'I am a very trusting person, so I tend to believe people in what they are saying to me. If I see things on the contrary...well I still believe that everybody is honest until it comes literally obvious that they are not. I do not tend to go out and to question people. I do not tend to be at all cynical. You need to be sceptical though in this profession. I am not sure whether I am though' (Ann).

An interesting interrelation between the pattern of auditors' responses in the questionnaire case study and the ways they perceived themselves on the job (interviews' data) emerged. That is, those auditors who perceived themselves in the interviews as structured thinkers were classified after an analysis of the questionnaire data as 'conventional practitioners'. That is, they complied well with the structure of 'risk-based' auditing, but they did not make a broader scope diagnosis on the client K plc. On the other hand, two individuals in the interviews perceived themselves as unstructured thinkers (Sarah and Justin). They were categorised after an analysis of the questionnaire data as 'big-pictured' since they were able to recognise in the particular characteristics of the K plc the case of NAS opportunities and fraud recognition (see chapter 6). Sarah recognised both, that is, she switched her attention from NAS opportunity in the first year to fraud recognition in the second year of the case study. Justin recognised fraud in the second year of the case study. Of the interviewees, Sarah and Justin were least comfortable with the structure of audit process. There were few exceptions in these findings. Russell who perceived himself as an unstructured thinker but compliant with the structure did not recognise either NAS opportunity or fraud flags in the case study, and thus, was classified under the category of 'conventional practitioners'. Ann who perceived herself as a structured thinker recognised fraud flags in the second year of treatment. Ernie who perceived himself as a structured thinker, recognised a need to see the 'big-picture' and switched from NAS recognition in the first year of treatment to fraud recognition in the second year of treatment in the case study. Ann, John, Andrew, Neil, Ernie and Stephen (perceived structured thinkers) were compliant and consistent with the structure of the 'risk-based' auditing in the case study while Stephan and Russell were not consistent with that structure. In the group of 'big-pictured' practitioners, Sarah was consistent with the structure of the case study while Justin was inconsistent. Table 7.3 presents the interviewees' self perceptions and background factors related to their actual performance in the audit process.

Table 7.3

**Auditors' perceptions related to actual audit performance:
Learning styles in judgement processes**

<i>Attitudes and perceptions Subject</i>	Self	Judgement performance	Background factors
Andrew	<ul style="list-style-type: none"> Fairly structured Logical thinker 	<ul style="list-style-type: none"> Importance of 'gut-feeling' Individual thinking Structure as benefit Breaking areas in judgement into pieces 	<ul style="list-style-type: none"> Accountancy degree Fraud experience
Ann	<ul style="list-style-type: none"> Analytical Systematic Number conscious Trusting 	<ul style="list-style-type: none"> Personal assessments Auditing as hard thinking 	<ul style="list-style-type: none"> Statistics and Economics joint degree
Ernie	<ul style="list-style-type: none"> Inclined to analytical thinking 	<ul style="list-style-type: none"> 'Big-picture' to learn Need for creativeness Fear of fraud 	<ul style="list-style-type: none"> Fraud experience Working class background
John	<ul style="list-style-type: none"> Naturally analytical Sceptical (learnt) 	<ul style="list-style-type: none"> Awareness of step-by-step format on audit Need to broaden thinking 	<ul style="list-style-type: none"> Accountancy degree
Justin	<ul style="list-style-type: none"> Creative Cynical Sceptical 	<ul style="list-style-type: none"> Reliance on intuition Methodology as guidance Importance of being attentive to fraud Need to adapt 	<ul style="list-style-type: none"> English and French degree Law degree Travel experience
Neil	<ul style="list-style-type: none"> Operating by the book Governed by rules and timetables Structured Logical thinker 	<ul style="list-style-type: none"> Need to balance judgement with structure Structure as guidance Role of structure in legitimacy 	<ul style="list-style-type: none"> Accountancy degree 'Rule following' and conservative family
Russell	<ul style="list-style-type: none"> Unstructured within structured work Sceptical (learnt) 	<ul style="list-style-type: none"> Understanding related to scepticism Structure to follow 	<ul style="list-style-type: none"> Accountancy degree Moved schools
Sarah	<ul style="list-style-type: none"> Assertive Unstructured Creative 	<ul style="list-style-type: none"> Individual judgement as personal value Auditor as consultant Constrained by structure 	<ul style="list-style-type: none"> German and Accountancy joint degree Fraud experience
Stephan	<ul style="list-style-type: none"> Analytical 	<ul style="list-style-type: none"> Importance of understanding (need to 'step back') Structure to follow 	<ul style="list-style-type: none"> Statistics degree
Stephen	<ul style="list-style-type: none"> Structured on audit 	<ul style="list-style-type: none"> Importance of embeddedness with clients Audit format to be followed 	<ul style="list-style-type: none"> Accountancy and Business Studies joint degree CA training as learning process

These findings of two prominent groups of thinkers with their different attitudes towards structure point towards the research tradition of individual cognitive styles. It is argued, that the individual organises and processes information by relating his/her judgements to modes of cognitive styles and that predetermines to some extent how the individual reads evidence in the context of promoted methodologies (Sadler-Smith and Badger, 1998). Prior auditing literature recognised the importance of cognitive styles in audit judgement and decision making (e.g. Bernardi, 1994; Pincus, 1990).

What tentatively emerges from the case study and interviews data is the fact that those auditors who are more structured and analytical in their thinking (as far as their perceptions allowed) take to codification more readily maintaining high accuracy over long spells of detailed work. This group characterises the precision, discipline and conformity with the structure of a logical method. The other group of auditors, those who are more unstructured, typify undisciplined thinking and tangential approaches to audit tasks. They seem to transcend the structure of audit methodologies, and read evidence well beyond the conventional practice of materiality and risk assessments and compliance with standards. With regard to their preferred ways of judgement and decision taking strategies, these auditors find work with structure difficult. Those auditors who were capable of deployment of both strategies, depending on the underlying circumstances, in particular, those who were able to switch their judgement scope from one year of treatment to the next were sub-classified as versatile thinkers (e.g. Sarah and Ernie). These categorisations imply that auditors have different ways of being (responding) with regard to audit judgement and decision making processes. These findings parallel Riding and Cheema's (1991) categorisation of individual strategies for judgement and decision taking; they distinguished two prominent groups, that is (w)holists and analysts (see chapter 3). In short, what emerges from the study is the fact that auditors envisaged as structured thinkers adopt more convergent strategies to idea production in judgement and decision taking whereas 'big-pictured' thinkers adopt divergent strategies to an idea initiation in the audit judgement strategies. The former deploy non-transcending structure strategies while the latter transcending. There were few exceptions from this categorisation above implying the impact of other unveiled elements of the audit milieu for judgement and decision making strategies.

It seems, that on the whole, the ways the auditors' judgmental strategies are formed is affected by their family background and education. These personally inherited values and behaviours (related to both affective and cognitive behaviours) are then reformed and deformed by professional experience in auditing practice. Some auditors find these processes of formation and socialisation easier than others.

7.5 The real story and the 'dream' in audit practice

The story of the 'realm of the real' in audit practice discussed the organisational and administrative change, which has come about as a result of the introduction of the new audit methodologies for strategic auditing. There were associated with concomitant structural problems and the auditors' concerns, in particular regarding the use of their subjective judgements in the context of legitimisation concerns over auditor's liability.

What emerged from Neil's discourse were the counterposed parts, which attested to an essential issue of what actually happens in the firm and, what would be a possible practice in the firm, that is the real state and the wished for. With regard to the structure and judgement metaphors embedded in a social and organisational context, the evident tensions are unveiled by the juxtapositioning of the real and the 'dream' (i.e. a state counterposed to the real). In particular, Neil being aware of changes in business, i.e. internalisation of commerce, sophistication of the clients, advances in technology, etc., proposed an intermediary institution between the audit and consultancy divisions to eliminate tensions between structural reality and judgmental strategies in the firm.

'I think the best way to deal with the tension between judgement and structure in the context of the methodologies is to set up an intermediary in the firm side. So the consultants would have their channel to the partner and perhaps to managers as well, and the same with the audit division. So you would have one figure head in the firm responsible for a service, in charge of all aspects of the service and every dealing would go through that. That would help from the client's point of view because everything would come from one person. But again, it could be very frustrating to come through this administrative route, especially from the consulting side, which would normally deal with the client personally. I am afraid it would not always work, because the consultant goes straight to the client. It would be ideal though if they could be educated to go through this intermediary. Saying that, from the start you would impress the client, build up the relationship by providing the client's management with the background knowledge we have on them – all from databases, it is available. You would have to educate your clients as well' (Neil).

Neil explained that he would envisage mixed teams on audit – combined of consultants and auditors – to diminish tensions and the pressures of seeking additional services (i.e. non-audit services) and to balance judgements.

'With regard to the knowledge on the client, it would disseminate in the best ways by having joint teams. Something like the design of a new system...it would be very difficult, because all members would have to be specialised within the audit firm. The training programmes would need to be redesigned and improved. Generally, the team would have a good knowledge of

systems, but not good enough to design and implement. Quite often you would find that there will be a system specialist as part of the audit team who reviews the systems as a part of the audit process. By using these specialists, it would almost bridge the gap between the consultants and the auditors, and would help a growing together in the audit firm. I think the aim here should be one big team. Certain people would do the audit and certain people design and implementations. It would give more space for judgements too. It would be easier for everyone. They would all be one part of working together, and more importantly it would be easier not to expose the firm' (Neil).

Neil's perceptions tie well with the study's findings; that is, with the emergence of the two different groups of thinkers among auditors deploying different strategies with regard to audit judgement and decision making within the structure of audit approaches (in the old and new contexts), namely 'conventional' and 'big-pictured' practitioners. Neil proposed the introduction of mixed teams on audit, combined of both auditors and consultants. The role of 'big-pictured' auditors would be to see the client's evidence beyond the layout of the audit process and to recognise the specific threats and/or opportunities in the client's environment for the audit firm. These threats (i.e. risks) and opportunities (i.e. for another services) would be recognised and assessed within the same team, and thus, would not cause any tensions, and/or would not deteriorate the quality of the service. There would be more areas for applying subjective judgements where a team-building spirit would provide more confidence for the legitimisation of each individual's work. Since conventional auditors are very good in following the structure of operational audit approaches, they could translate the 'big-picture' context of the client into the structured inquiry, and in that sense, they would justify the legitimatisation of subjective judgements even further. The use of consultants and auditors in one team would provide the benefits for the firm in the form of a wider combined knowledge of the client, i.e. the client would benefit from knowledge spillovers flowing from within the audit firm.

7.6 Summary

The interpretation of auditing as a hermeneutic practice draws attention to the social context of the audit work, the underlying processes of that work, the meanings that auditors attach to their work, and to the affective aspects of those meanings. These interpretations have important implications for the ways in which audit judgement can be understood, and thus discerned. Insights from the auditors' stories confirmed the existence of different attitudes to tensions between judgement and structure categories in the audit process; that is transcending and non-transcending of structure practitioners.

What emerged from interviews is evidence that auditors' judgement strategies are affected by standardisation in audit practice; that is, formed and reformed by socialisation processes within the audit firm and through professional training. Hence, it seems that the auditors' judgement strategies are impeded by the structure of the operational audit approaches ('risk-based' auditing). Auditors' personality traits, family background and individual experiences seem to affect the extent of the structural impediment of audit judgement. These personal characteristics affect the ways in which the auditor applies existing rules and frameworks to complex client's problems (i.e. the level of subjectivity and criticism applied in the processes of interpreting the client).

What can be discerned from the auditors' story are recommendations for mixed audit teams combined of transcending (with a 'big-pictured' mode) and non-transcending (with a conventional mode) of structure of the audit process practitioners. The mixed audit teams are perceived as more judgmental in nature, but backed up by the capacity for focused inquiry of the conventional practitioners. The role of 'big-pictured' auditors would be to see the client's evidence beyond the layout of the audit process and to recognise specific threats and/or opportunities in the client's environment. Since conventional auditors are good in following the structure of operational approaches, they would be able to translate the 'big-picture' into structured inquiry. These mixed teams would have the capacity to diminish tensions between judgement and structure metaphors, and to mediate between the demand for high quality in the audit services (fraud recognition) and pressures to be attentive for non-audit services' opportunities.

Further, what was revealed from the auditors' story of the 'realm of the real' is the impact of organisational change; that is, the introduction of the new operational audit methodologies of strategic auditing and the associated issues. The problems related to these new methodologies are linked to existing legitimacy processes, as the auditor is expected to execute more subjective judgements on a wider scale which is 'backed up' with less working papers on the audit file. On the other hand, there are some indications that these new audit methodologies of strategic auditing are essentially adapted versions of previous approaches, not genuinely different ones. In that sense, they are expected to be more or less tailored from the basis of the old ones i.e. 'risk-based' auditing.

Audit judgement research has conceptualised auditing primarily as a cognitive process (Trotman, 1997). Within this paradigm, there is no way to account for the significance of subjectivity (i.e. 'gut feeling') in the formation of the audit decisions. The essential point emerging from the auditors' story is the fact that the auditors need to achieve an emotional state

with respect to their work, not just a cognitive one; there is affect as well as a cognition, both of which are critical to the understanding of audit judgement. Pentland (1993) argued that any attempt to construct a purely rational explanation of auditor's behaviour fails. This is due to the insufficiency of rule-following as an explanation of a social order in the auditing milieu which consists of many complex and unquantifiable elements (see chapter 3).

'For any given rule, one must decide when to apply it, which requires more rules, each of which requires even more rules' (Pentland, 1993, p. 619).

To reach the conclusions, in the absence of the rules or in the context of their ambiguity, the auditor relies on the emotional resources generated by 'gut feeling'. The interviewees perceived their subjective and independent judgement as an inherited quality, as second nature. In order to activate critical awareness and independent and subjective reasoning in audit judgement processes, holistic approaches to auditors' education should be promoted. Within such an approach to education, the auditor would be able to embrace rather than simplify the complexity inherent in the economic reality of the client's text and its environment.

Chapter 8

Conclusions and implications for further research

8.1 Introduction

This study set out to provide insights into auditors' individual judgement and decision making processes. In particular, the study describes general approaches held by auditors at the planning stage of audit in relation to the 'micro-structure' of independence of judgements in circumstances when the audit environment is obfuscated by NAS opportunism and 'risk-based' audit methodologies are promoted within the audit firm.

Through both engaging with auditors' frames of references and undertaking critical reflection of particular micro-processes at the level of the individual auditor embedded in a wider environment, the study sought to enhance the understanding of audit praxis. The findings refer, in particular, to the scope of auditors' judgements. What emerges is evidence that auditors respond to the changing circumstances of the client's environment in varying ways consistent with their different attitudes to the dynamics between judgement and structure. These differences were used to categorise auditors into two classes: transcending and non-transcending practitioners.

The conclusions of the study are drawn from the two-stage process of the research design; that is, discussed in the context of both experiment and interview findings. At the first stage of the research, the questionnaire-based experiment incorporating a real-life construct was conducted. In the questionnaires, the subjects (i.e. the population of senior auditors and audit managers from the Big Five auditing firms) were asked to compose an audit planning memorandum and subsequently to assess the audit risk and to estimate a budget of hours for audit testing. The second stage of the research involved interviews incorporating a process-tracing exercise. The process tracing allowed the examination of judgement formulations over the case material (i.e. the composition of the audit planning memorandum) and provided further evidence for the categorisation of the questionnaire respondents. Interviews also enabled location of the study in a wider socio-organisational context and provided insights into operational judgement strategies relating in particular to auditors' background and experiences. Research methods were discussed in chapter 5.

This final chapter presents the conclusions of the study and discusses areas for further research. The remainder of this chapter is organised as follows. Firstly, the dynamics between judgement and structure categories in audit are discussed, addressing the issue of audit independence. In the subsequent section, the incidence of auditors' anchorage is explained; that is, the incidence of the mutual exclusivity of a fraud flag and an NAS opportunity recognition. The results of an

examination of the relevance of different learning styles in the recognition of fraud embedded in a structured audit environment are presented in the following section. The results offer indicative evidence with regard to the implications of different cognitive strategies in the audit judgement processes being consistent with different attitudes to judgement and structure. The dynamics between judgement and structure categories are then discussed in the light of organisational change; that is, in the context of implementation of new audit methodologies for strategic auditing. Finally, implications for further research are discussed.

8.2 Insights into operational and apparent independence: Dynamics between judgement and structure categories in the audit process

The experiment findings, which can be found in chapter 6, provide insights into auditors' judgement processes with regard to fraud recognition and their decisions regarding the estimation of a budget of audit hours for audit testing at the planning stage of the audit, in a particular micro-context of K plc's environment. Two categories of auditors emerged: (1) transcending and (2) non-transcending practitioners. Differences in auditors' attitudes with regard to judgement and structure impact on the independence of their audit performance. In the group of non-transcending auditors, structure of operational audit approaches delimits and pre-empts the auditor's ability and freedom to determine the scope and criteria of judgement, that is, structure restrictions affect auditors' operational independence. In the group of transcending auditors, the threat of loss of independence seem to be associated more with judgement restrictions with regard to the amount of work assigned for audit testing (i.e. despite awareness of higher risk, these auditors tended not to increase, or in some cases decreased the budget of hours for audit testing); that is, with apparent independence. On the whole, the evidence indicates that a semi-structured approach is overused in audit (in the context of 'risk-based' auditing) and forms an obstacle to performance in fraud recognition. Hence, audit judgement strategies seem affected by standardisation in audit practice.

The findings disclosed the differences in auditors' attitudes towards the dynamics between judgement and structure. In the group of non-transcending practitioners, the auditors tended to apply a more conventional mode to audit determined by the framework of 'risk-based' audit methodologies. These auditors took to the codification more readily; thus, codification then translates into frequently exercised 'black-box' oriented judgements (i.e. such judgements indicate 'orthodoxy' of risk and materiality assessments). They tended to read the case of K plc in terms of audit (non fraud) risk and materiality, without addressing either fraud or non audit services. In other words, they may recognise the possibility of fraud whilst not being able to label it. This group is characterised by highly structured thinking which is manifested by treating the audit more as a technical activity than a conceptual process. It could be argued that such an approach to audit delimits and pre-empts the scope of judgement and, as a result, the 'big-picture' orientation in audit is constrained. Hence, structure restrictions seem to affect non-transcending auditors'

operational independence; that is, the auditor's ability and freedom to determine the scope and criteria of judgement.

The group of transcending practitioners, being less constrained by the structured audit approach, represent a 'big-picture' perspective. These auditors are able to go beyond the structure of operational approaches so as to penetrate the particular micro-context of the client's environment. Into this category fall those auditors who recognised fraud or NAS opportunity in either of the two years of treatment. Hence, the group of transcending practitioners is further divided between two sub-categories: 'big-pictured'-versatile and versatile-switchers. The 'big-pictured'-versatile are those who changed the anchor of the 'big-picture' from NAS focus in year 1 of treatment to fraud recognition in the second year. When the underlying circumstances of the client were evident of fraud and/or NAS opportunity those auditors were prepared to see the client in a wider scope and thus demonstrated their capacity for versatile judgements ($NAS1 > F2$). The switchers-versatile represent those auditors who changed the orientation of their judgements from a conventional mode in year 1 to a 'big-picture' mode in the second year, i.e. either to fraud recognition ($C1 > F2$) or to NAS recognition ($C1 > NAS2$). On the whole, for transcending auditors, the threat of loss of operational independence seems insignificant since they are capable of, depending on circumstances, transcending structure restrictions determined by the format of 'risk-based' auditing.

In short, different patterns of judgement performance emerged; that is, (1) conventional (i.e. non-transcending of structure practitioners) and (2) 'big-pictured' orientations subdivided between 'big-pictured'-versatile and versatile-switchers (i.e. transcending of structure practitioners). The statistical testing explored to what extent these different groups of auditors perform differently in the context of 'risk-based' auditing at the planning stage of the audit process. From the analysis of the auditors' consistency with regard to the structure of the 'risk-based' audit approach it could be argued that the majority of conventional auditors (70 %) were more compliant with the structure of the audit task in comparison with the group of 'big-pictured' practitioners. In particular, 57 % of subjects in the group of 'big-pictured'-versatile ($NAS1 > F2$) were compliant with structure whilst in the group of late NAS recognisers ($C1 > NAS2$), 27 % of subjects were compliant with structure. Thus, it could be argued that differences in structure consistency are associated with the auditors' different approaches to balancing structure and judgement categories. An alternative explanation for these differences could be associated with an apparent independence threat, in particular in the group of late NAS recognisers ($C1 > NAS2$). A significant proportion of auditors in this group did not increase (or change) the budget for audit testing, being 'deflected' from the fraud problem despite an awareness and estimation of high risk in K plc. Hence, for the 'big-pictured' auditors, the threat of loss of independence may be associated with the judgement restrictions with regard to the amount of work assigned for audit testing; that is, with apparent independence.

A significant proportion of the auditors (40 % of subjects) did not see either fraud or NAS opportunity in K plc despite the characteristics of the case evident of fraud risk and weak internal controls (i.e. a need for consulting service). This indicates that some auditors, by conforming to the format of 'risk-based' audit methodologies were unable to 'see' the client through the wider lenses of judgement. These auditors, that is, the group of conventional auditors, are consequently prone to the operational independence threat. It could be argued, however, that some auditors were unwilling to see 'big-picture' scope judgements, and despite the awareness of fraud clues, chose not to engage with fraud problem, 'following' the format of materiality and risk assessments. In such instances, the apparent independence threat seems to be masked by an operational independence threat. In other words, those auditors may have used the conventional structure of audit in order to avoid involvement with fraud despite possessing knowledge of fraud flags. Thus, the tentative conclusion is that a formal structured approach to auditing becomes a potential threat to fraud discovery (i.e. operational independence threat). This is an enduring concern since fraud experience is not easily codified to facilitate structured inquiry. In other words, the concept of fraud is not easily codified as audit knowledge within a structured audit framework. It requires auditors' creative and critical thinking within a highly diffused and holistic environment.

Statistical analysis offers indicative insights as to the individual decision making processes associated with independence of audit judgement. However, since the power of non-parametric tests is somewhat limited with regard to sophisticated judgement and decision making processes, further research, both qualitative and quantitative, needs to be addressed to substantiate the results as to whether NAS opportunism affects auditors' structure consistency in judgement processes.

Narrative analysis (the second stage of the research) sought to explore the deeper aspects of auditors' performance in judgement processes; dimensions which may have been opaque in the statistical analysis. In particular, the interviews set out to clarify how selected participants perceived themselves as dealing with the tensions between judgement and structure categories and how they related these perceptions to their personality and background factors. Insights from the auditors' stories confirmed the existence of different attitudes to tensions between judgement and structure in the audit process; that is, the two distinct groups of transcending and non-transcending practitioners emerged (corresponding with patterns in the case study experiment). The interviewees perceived their performance in audit differently. The group of auditors compliant with the structure of operational approaches was predominant. These auditors perceived themselves as structured and analytical thinkers. At the first stage of the research they too were categorised as non-transcending practitioners. At the interview stage, two interviewees described themselves as 'big-picture' orientated practitioners. They had been categorised as such at the first stage of the research. These interviewees expressed their overall reliance on emotional resources

and intuition in audit judgement processes generated by 'gut feeling' and perceived their subjective and independent judgements as an inherited quality. They perceived such thinking as being of second nature to the auditor and enabling of critical thinking and maintenance of a sceptical attitude. Hence, what emerged from the interviews is evidence that audit judgement strategies are affected by standardisation in audit practice.

The interviews confirmed that audit judgement processes are impeded by the structure of the operational audit approaches promoted by the audit firm (an operational independence threat). Some auditors believed that the balance between judgement and structure metaphors needs to be achieved in order to enhance quality in audit, and subsequently to increase an incidence of fraud recognition. Further, some auditors regarded the presence of structure as existing for the benefit of the practitioner. In their view, structured audits legitimated liability status of the auditor. Hence, it could be argued that there is a hidden agenda within the audit firms regarding the balance between judgement and structure categories. Judgement strategies are formed and reformed by socialisation processes within the audit firm and shaped by the professional training ('risk-based' auditing training). The auditor needs to learn the 'craft' of auditing to apply both judgement and structure so as to enable the 'big-picture' orientation of the client's affairs within the structured inquiry.

8.3 Insights into anchorage in audit judgement

In the process of constructing the audit planning memorandum (i.e. at the experiment stage), auditors did not consider fraud flags and an NAS opportunity simultaneously in the same year of treatment. Thus, what emerged from the study is evidence of the mutual exclusivity of fraud and NAS recognition. Such incidence confirms the ability of 'big-pictured' practitioners to adapt their judgmental orientation to new, unknown situations and validates the existence of two sub-categories of 'big-pictured' practitioners; that is, the 'big-pictured'-versatile and the switchers-versatile.

The findings suggest that early NAS recognisers were also fraud recognisers (in the second year of treatment). The majority of early NAS recognisers (93 %) were able to switch their judgement focus from NAS opportunism to fraud recognition in the second year ($NAS1 > F2$). Those auditors were capable of responding to both NAS and fraud dimensions depending on the circumstances of the client. Further, nearly a half of the conventional group in the first year of treatment (49.2 %) became 'big-pictured' in the second year of treatment ($C1 > NAS2$ and $C1 > F2$). Hence, early NAS recognisers ($NAS1$) tended to switch to fraud recognition ($F2$) in the second year, but initial recognition was affected since late NAS recognisers ($NAS2$) seemed to be deflected from awareness of the fraud problem. In the group of late NAS recognisers ($C1 > NAS2$), there is an evident risk of the apparent independence threat, since those auditors may have used a conventional structure of audit in order to avoid engagement with the fraud problem despite their

awareness of fraud clues. Further, these auditors did not increase a budget for audit testing despite an awareness of the higher risk. Whilst one aspect of the study has its origins in concerns that the existence of NAS opportunism diverts attention from fraud recognition, the results reveal only limited evidence to support these concerns. The dynamics of NAS opportunism deflecting the probability of fraud recognition needs to be addressed as an area for further research, in particular in relation to issues of apparent organisational independence. Further, it could be argued that the structure of 'risk-based' auditing 'bands' the 'big-picture' judgements in the sense of delaying fraud recognition. Further research would need to be carried out to substantiate this argument.

The auditor needs to learn to balance judgement and structure on audit so as to enable the 'big-picture' of each client within the structured environment. The auditors seem to respond differently to these learning processes.

8.4 Insights into learning styles in judgement processes: Towards the convergence of judgement scope

The findings of two predominant groups of auditors with their different attitudes towards the dynamics between judgement and structure (transcending and non-transcending practitioners) point towards the research tradition of cognitive learning styles. Prior auditing literature recognised the importance of cognitive styles in audit judgement and decision making (e.g. Bernardi, 1994; Pincus, 1990).

What emerges from the case study and interview data is evidence that those auditors who are more structured and analytical in their thinking take to codification more readily, maintaining high accuracy over long spells of detailed work. This group characterises the precision, discipline and conformity with the structure of a logical method (i.e. 'risk-based' auditing). They represent the category of non-transcending practitioners. The other groups of auditors (those who are more unstructured), typify undisciplined thinking and tangential approaches to audit tasks. They seem to transcend the structure of audit methodologies and read the client's case beyond the conventional practice of materiality and risk assessments and compliance with standards. With regard to their preferred ways of judgement and decision taking strategies, these auditors find work with structure problematic, and sometimes impossible to conform to. These auditors represent the category of transcending practitioners. The findings of this study correspond with Riding and Cheema's (1991) categorisation of individual strategies for judgement and decision taking. They distinguished two prominent groups of individuals in organisations; that is, (w)holists and analysts (see chapter 3).

In short, what emerges from the study is the fact that auditors envisaged as structured thinkers adopt more convergent strategies to ideas' production in judgement and decision taking whereas 'big-pictured' thinkers adopt divergent strategies to ideas' initiation in the audit judgement

strategies. Hence, the former deploys non-transcending structure strategies while the latter are transcending of structure. There were a few exceptions from this categorisation implying the impact of other unveiled elements of audit milieu on judgement and decision making strategies.

The auditors' discourses demonstrated a partially unconscious link between their ways of thinking 'on audit' and their personal background and experience. The majority of analytical thinkers; that is, those compliant with structure did numeracy oriented degrees at the university (i.e. accountancy or statistics) while interviewees who perceived themselves as 'big-pictured' auditors did combined degrees. The 'big-pictured' further perceived themselves as naturally inquisitive, critical and self-confident individuals whereas some conventional auditors found the attitude of professional scepticism difficult to acquire and subsequently to deal with. As the education processes enable particular forms of learning, it could be argued that the accountancy degree in the UK is too narrowly focused on issues of knowledge transfers in the context of stable systems and thus, inadequately prepares auditors for the job in a changing and turbulent environment.

Personality traits, family background and individual experiences seem to affect the extent of the structural impediment of audit judgement. In other words, these personal characteristics enable the auditor's ability to apply existing rules and frameworks to complex client's problems so as he/she applies more or less subjectivity and criticism in the processes of interpreting the client. It could be argued that in order to activate critical awareness and independent reasoning in the audit judgement processes and to broaden individual thinking capacities within underlying frameworks, holistic approaches to education should be promoted. A more holistic approach could be introduced into audit training curriculum. Professional judgement in audit should be grounded in a comprehensive understanding of the business, the way it generates value and creates the sustainability of its competitive advantage. In the absence of such comprehensive decision frames, there is no way of knowing when and the extent to which judgements in audit are misguided or obfuscated. With more holistic approaches to education, the auditor would be able to embrace rather than simplify the complexity inherent in the economic web of interrelations within the client's business and the client's business environment.

Since evidence reveals that auditors tend to respond differently to the changing circumstances of the client environment consistent with their different attitudes to structure affecting their judgement performance, mixed teams could be built in audit in order to increase fraud recognition. That is, the audit teams should consist of those auditors who see the 'big-picture' and those who are able to operate within structured audit formats. The role of 'big-pictured' auditors would be to see the client's evidence beyond the layout of the audit process and to recognise the specific threats and/or opportunities in the client's environment. Since conventional auditors are good in following the structure of operational audit approaches, they could translate the 'big-picture'

context of the client into the structured inquiry, and in that sense they would justify the legitimisation of subjective judgements.

The introduction of teams in audit, combining both auditors and consultants may also be advantageous. There are more areas for execution of subjective judgements when the distinction between audit and consulting becomes blurred. In redesigned audit processes a team-building spirit would provide more confidence for the legitimisation of each individual's work.

There are on-going efforts in practice to improve the quality of audit whilst simultaneously creating value added from audit services. Hence the use of consultants ('para-auditors') and auditors in one team would provide benefits for the firm in the form of combined knowledge regarding the client, i.e. the client would benefit from knowledge spillovers flowing from within the audit firm. Threats (i.e. risks) and opportunities (i.e. for other services, e.g. NAS) would be recognised through knowledge transfers and assessed within the same team, not causing tensions with regard to priorities of individual team members. The quality of audit, in particular in respect of fraud recognition, would be enhanced, simultaneously maintaining commercial awareness of the service.

8.5 Insights into dynamics between judgement and structure embedded in organisational change: The nature of new audit methodologies

The interviewees' perceptions with regard to judgement and structure categories allowed access to the auditors' concerns associated with current structural and organisational changes in audit practice regarding the introduction and implementation of the new audit methodologies. The new approaches are regarded as more strategic in comparison with 'risk-based' methodologies addressing key business risk areas rather than financial statements risk. In other words, whilst 'risk-based' audit focuses the auditor's assessment of risk in a way that ensures that financial statements assertions are not materially misstated, strategic audit focuses the auditor's assessment on key business risks of the client placing the client at the core of a broader socio-economic system (Bell et al., 1997).

The on-going organisational change focuses on the need to develop expectations at the entity level; that is, expectations which are not influenced significantly by the assertions being audited and that relate to the client's organisational fit within its broader socio-economic system. In the context of new methodologies, once the auditor gains an understanding of management regarding: (1) process for identifying and controlling business risks, and (2) perceptions and assumptions about those risks, he/she can assess the business risk implications both for the client's business and for the audit approach (Bell et al., 1997).

To characterise the new operational approaches, the auditors pointed out the necessity for the use of specialists in order to manage the key business risks and to improve client's services. They also suggested a requirement for continuous debriefing (i.e. continuous assessment with more time spent in an audit team), since documentation on a file decreased to a minimum with an introduction of new methodologies. The auditors perceived the major differences between old and new methodologies with regard to the execution of judgement. They argued that, in the context of 'risk-based' methodologies, judgement used to be applied on financial reporting issues, accounting estimates and in ensuring an adequate scope of the substantive testing. Within the framework of the new audit methodologies judgement was perceived as broader and more subjective in nature. On the whole, the interviewees believed that the new audit methodologies enable the grounding of judgements in a more holistic and critical understanding of the client and its business environment and the interpretation of the role of significant transactions for this business knowledge frame. This broader context was perceived as assisting the infusion of meanings into the key business risks areas. There were a few auditors however, who argued that judgement did not change in the context of the audit process framed by the new methods for strategic auditing. One respondent, for example, argued that professional judgement is always present in audit, despite the operational approaches in use. This conclusion followed from the perception that nowadays individuals are more risk aware, so as they tend to use their judgements more extensively. Some auditors perceived the organisational change as no more than a re-packaging and re-jargoning process. The interviewees emphasised that the new approaches still embrace the audit risk model allocating audit effort on the basis of risk assessments and performing procedures similar to conventional audits (i.e. 'risk-based' approaches). Hence, there is some indication that new methodologies will become a tailored version of old methodologies; that is, 'prescribed' in the structure of 'step by step' audit operational approaches. It could be argued that integrated risk management overseen by the auditor may represent the best opportunity to align policy. To facilitate the operationalisation of strategic audit approaches, a regulatory system needs to put more emphasis on the self-monitoring of the auditor including the compliance element as a form of legitimacy. Whether the regulator will guide the new methodologies back to the rule-based form and whether the new audit methodologies will become a tailored version of 'risk-based' approach will become evident in practice, probably within a year or two.

It could be argued that the operational independence threat (concerned with the auditors' ability to apply subjective judgement) seems to be less prominent in the context of the new audit methodologies. That is, a compliance dilemma between the internal policies and procedures of the firm's conduct and the auditor's subjective judgements is less evident in this new context, since the auditors are more aware of the requirement for critique and subjective reasoning. Further, strategic audit methodologies appear beneficial in the sense of enhancement of organisational learning processes resulting in epistemological dualism between auditing and consulting. However, the

problems associated with the new methodologies are related to legitimacy processes, regarding the liability status of the auditor (i.e. the new methodologies are characterised by less working papers, more verbal evidence, and in the context where clients continue to develop greater sophistication).

'No longer is the concern that judgement is driven out by process and a compliance mentality, but rather the concern is the exact opposite, i.e. that the analysis of business risk and its relationship to audit risk is *too* judgmental for the audit reliance being placed upon it' (Hatherly, 1999, p. 59, emphasis added).

The auditors shared some uncertainty with regard to organisational change and on the whole they perceived themselves as vulnerable in the context of the on-going structural transition. In particular, they expressed uncertainty over the legitimacy processes regarding their liability whilst adopting subjective judgements. It could be argued that the use of more subjective judgements in the context of new methodologies needs to be recognised within strategic decision processes by judgement management at all levels of audit staff in the firm. The audit environment should be one in which auditing can be sustained as a professional judgement. Hence, with the introduction of the new audit methodologies, the whole internal culture of the audit firm needs to be reconstructed and holistic approaches to education and internal training promoted.

8.6 Implications for further research

What emerged from the study is evidence that audit judgement strategies are affected by standardisation in audit practice. Within the context of 'risk-based' auditing, the profession successfully presented behind the label of 'professional judgement' a sense of elusiveness over the scope of operational audit practice. Hence, it could be argued that the structure of 'risk-based' auditing delimits the 'big-picture' judgements in the sense of delaying fraud recognition (i.e. an operational independence threat). A similar case study based experiment on audit judgement and decision taking in a context of the operationalisation of the strategic auditing approaches would be valuable to examine the extent to which new audit methodologies mediate operational sense of independent judgement. In addition, field research and ethnographic study of the Big Five firms' culture in this new setting would be of value.

Whilst one aspect of the study had its origins in concerns that the existence of NAS opportunism diverts attention from fraud recognition, the results revealed only limited evidence to support these concerns. It could be argued that pressure from the audit firm on the auditor to recognise and to pursue NAS opportunities has a limited impact on auditors' behaviour in judgement processes. The dynamics of NAS opportunism deflecting the probability of fraud recognition needs to be addressed as an area for further research, in particular in relation to apparent organisational independence.

8.7 Summary

The preoccupation with apparent independence somewhat precludes the academic debate regarding operational independence, i.e. the capacity of the auditor to freely decide the scope of audit and to assign audit procedures accordingly. More research on operational independence needs to be conducted in order to understand the environmental and behavioural aspects of independent judgement performance. Research into the motivational and environmental factors in audit judgement and decision-making have recently emerged (Trotman, 1997). Auditing research should not underestimate the significance of a network of elements within the audit milieu where independent judgement is embodied in the wider context of social institutions and structural, organisational conditions. Theoretical approaches attempting the explication of this wider context should encompass the dynamics between action (judgement) and structure categories.

Interest in the independence of audit judgement will continue, and alternative ways of thinking about audit judgement will be sought since new situations emerging in the turbulent reality of the audit milieu may bring new threats to the meaning of independent audit judgement. A continuing interchange between the profession and society around the issues of independence and responsibilities of auditing suggests that the legitimacy processes in the audit milieu and corresponding systems of abstract knowledge are social in nature and thus, destined to be continually contested, redefined and modified as social interpretations. This study attempted to contribute to those issues through the examination of independent audit judgement processes embedded in the 'orthodoxy' of its practice.

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APPENDIX 1
QUESTIONNAIRE
INSTRUCTIONS

The questionnaire consists of three short sections A, B, C to be completed on an individual basis. Section A asks for background information. Sections B and C include a concise case study, split into a year 1 scenario and a year 2 scenario, each followed by a short series of questions.

Section A Please answer the demographic questions numbered from 1 to 5. Turn to section B after completion.

Section B Please read the year 1 scenario and answer the questions from 6 to 10. Proceed to section C. Do not read section C before completing section B.

Section C Please read the year 2 scenario and answer the questions from 11 to 15.

Please use a ball point pen. Thank you for your assistance.

SECTION A
BACKGROUND INFORMATION

1. Please state your age

___ years

2. Please indicate your sex

male/female

3. Please state the number of years you have been working in the audit function

___ years

4. Please, tick (√) the box indicating your position in the firm:

(a) audit assistant ☐

(b) audit senior ☐

(c) audit supervisor ☐

(d) junior manager ☐

(e) senior manager ☐

5. Please, tick (√) the box indicating your plans for career development. Do you wish to:

(a) remain in the audit department within the firm, e.g. become an audit partner ☐

(b) move to another department within the firm, e.g. consulting ☐

(c) move into industry or commerce ☐

(d) other, please specify _____ ☐

SECTION B

CASE STUDY YEAR 1 – CASE A

Your firm has recently acquired a new audit client (K plc) as a result of a competitive tender. K plc is a small listed company which assembles and installs sophisticated laboratory equipment for several hundred customers internationally in both the private and public sectors. In some cases European Union grants are available to K's customers on the purchase of research equipment. K plc has a reputation as a successful and well run company. For purposes of the tender it had not been possible to carry out a detailed appraisal of K plc's systems but on the basis of the company's business, its reputation and discussions with K's directors, the prospective client had been assessed as a low engagement risk. Its most recently available financial statements show turnover of £200m, after tax profit of £10m and capital employed of £180m. The audit fee specified in the winning bid is £60,000.

You have been given the responsibility of conducting the initial audit visit to K plc. The client's financial year still has a short while to run. You performed this visit to K plc earlier today and have just returned to the office. During the visit you had a conversation with the Finance Director. He advised you that recently there were difficulties with the sales record-keeping system.

K plc has an old computerised system for dealing with sales. In recent years new types of sales contracts have been introduced and some cannot be dealt with by the existing computer system. For these, therefore, invoicing is done manually and the details are entered into the sales ledger by journal entry. You are advised that the recent problems have arisen when inadequately experienced staff had conducted the manual preparation of invoices and journals and that errors resulted.

However, K's management have assured you that suitable staffing is now allocated to the sales record-keeping and that although processing errors have occurred, an exercise is well underway to identify and correct them. A necessarily quick review of the journal indicates that the value of the invoices processed manually is around 10 % of total sales.

Other systems are reported to you as working satisfactorily.

SECTION B

CASE STUDY YEAR 1 – CASE B

Your firm has recently acquired a new audit client (K plc) as a result of a competitive tender. K plc is a small listed company which assembles and installs sophisticated laboratory equipment for several hundred customers internationally in both the private and public sectors. In some cases European Union grants are available to K's customers on the purchase of research equipment. K plc has a reputation as a successful and well run company. For purposes of the tender it had not been possible to carry out a detailed appraisal of K plc's systems but on the basis of the company's business, its reputation and discussions with K's directors, the prospective client had been assessed as a low engagement risk. Its most recently available financial statements show turnover of £200m, after tax profit of £10m and capital employed of £180m. The audit fee specified in the winning bid is £60,000.

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However, K's management have assured you that suitable staffing is now allocated to the sales record-keeping and that although processing errors have occurred, an exercise is well underway to identify and correct them. A necessarily quick review of the journal indicates that the value of the invoices processed manually is around 10 % of total sales.

Other systems are reported to you as working satisfactorily.

K's management acknowledge the need to design and implement a new sales invoicing and recording system. They advise you that this assignment will be put out to tender and that your firm will be invited to bid.

SECTION B

CASE STUDY YEAR 1 – CASE C

Your firm has recently acquired a new audit client (K plc) as a result of a competitive tender. K plc is a small listed company which assembles and installs sophisticated laboratory equipment for several hundred customers internationally in both the private and public sectors. In some cases European Union grants are available to K's customers on the purchase of research equipment. K plc has a reputation as a successful and well run company. For purposes of the tender it had not been possible to carry out a detailed appraisal of K plc's systems but on the basis of the company's business, its reputation and discussions with K's directors, the prospective client had been assessed as a low engagement risk. Its most recently available financial statements show turnover of £200m, after tax profit of £10m and capital employed of £180m. The audit fee specified in the winning bid is £60,000.

You have been given the responsibility of conducting the initial audit visit to K plc. The client's financial year still has a short while to run. You performed this visit to K plc earlier today and have just returned to the office. During the visit you had a conversation with the Finance Director. He advised you that recently there were difficulties with the sales record-keeping system.

K plc has an old computerised system for dealing with sales. In recent years new types of sales contracts have been introduced and some cannot be dealt with by the existing computer system. For these, therefore, invoicing is done manually and the details are entered into the sales ledger by journal entry. You are advised that the recent problems have arisen when inadequately experienced staff had conducted the manual preparation of invoices and journals and that errors resulted.

However, K's management have assured you that suitable staffing is now allocated to the sales record-keeping and that although processing errors have occurred, an exercise is well underway to identify and correct them. A necessarily quick review of the journal indicates that the value of the invoices processed manually is around 10 % of total sales.

Other systems are reported to you as working satisfactorily.

K's management acknowledge the need to design and implement a new sales invoicing and recording system. They have placed this assignment with outside consultants unconnected with your audit firm.

SECTION B CASE STUDY YEAR 1 - QUESTIONS

6. On the basis of your visit and without any further preliminary work you have to write a memorandum for audit planning purposes. Print (briefly) in the space below the most important points you would wish to make.

7. Based on the information you have to date and following your visit, please indicate on the scale below how you would initially assess the risk of K's financial statements containing a material misstatement, when they are put forward for audit.

1 _____ 2 _____ 3 _____ 4 _____ 5 _____ 6 _____ 7 _____
Negligible Risk Moderate Risk Extremely High Risk

8. Assuming the tender bid was based on 35 budgeted hours for the audit of the sales cycle, would you argue that the budget hours for the sales cycle need to be increased, remain the same, or reduced, as a result of the findings of your visit?

Please tick (✓)
increase
remain
reduce

9. If you think that the hours budgeted should change, what figure would you argue for as the new budgeted hours for the audit of the sales cycle?

_____ hours

10. If you seek an increase for the number of hours required to audit the sales cycle would you recommend that your firm:

Please tick (✓)

- a) compensate by reducing the number of hours spent on other aspects of the audit
- b) seek an increase in the audit fee to cover the extra hours
- c) accept that the audit fee will not cover the increase in costs
- d) other, please specify _____

PLEASE DO NOT AMEND THESE ANSWERS AFTER READING SECTION C

SECTION C

CASE STUDY YEAR 2 – CASE A

At the end of year 1 the auditors (your firm) were satisfied that the internally launched exercise had identified and corrected the errors in the sales system. Following the audit for year 1 an unqualified audit report was issued on year 1's financial statements.

During the later stages of year 2 you visit the client and ascertain that last year's efforts to improve the manual operations within the system have not succeeded and errors are still occurring. K's management assure you that a similar exercise to that performed last year will be carried out to identify and correct errors ahead of completing the financial statements for year 2.

K's management acknowledge the need for the detailed design and implementation of a new sales invoicing and recording system. They advise you that this assignment will be put out to tender and that your firm will be invited to bid.

SECTION C

CASE STUDY YEAR 2 – CASE B

At the end of year 1 the auditors (your firm) were satisfied that the internally launched exercise had identified and corrected the errors in the sales system. Following the audit for year 1 an unqualified audit report was issued on year 1's financial statements.

Your firm's management consulting group won the tender to design and implement the new system, which is due to become operational at the beginning of year 3.

During the later stages of year 2 you visit the client and ascertain that last year's efforts to improve the manual operations within the system have not succeeded and errors are still occurring. K's management assure you that a similar exercise to that performed last year will be carried out to identify and correct errors ahead of completing the financial statements for year 2.

At the end of year 2 your firm's consulting division reports to you their concerns that K's management are insistent upon the sales system incorporating unusual features which, according to the consultants, would allow K's management to backdate accounting entries with respect to sales, without trace.

SECTION C

CASE STUDY YEAR 2 – CASE C

At the end of year 1 the auditors (your firm) were satisfied that the internally launched exercise had identified and corrected the errors. Following the audit for year 1 an unqualified audit report was issued on year 1's financial statements.

During the later stages of year 2 you visit the client and ascertain that although the outside consultants have designed the new sales invoicing and recording system, there are continual delays in commissioning it. K's management claims that there are design faults and that the consultants are failing to implement the system properly. There is a dispute between K plc and their outside consultants.

Last year's efforts to improve the manual operations within the system have not succeeded and errors are still occurring. K's management assure you that a similar exercise to that performed last year will be carried out to identify and correct errors ahead of completing the financial statements for year 2.

SECTION C CASE STUDY YEAR 2 - QUESTIONS

11. On the basis of the information you have to date you have to write a memorandum for audit planning purposes in respect of the second year's audit. Print (briefly) in the space below the most important points you would wish to make.

12. Based on all the information you have to date and following your visit, please indicate on the scale below how you would assess the risk of K's financial statements containing a material misstatement, when they are presented for audit later this year.

1 _____ 2 _____ 3 _____ 4 _____ 5 _____ 6 _____ 7 _____
Negligible Risk Moderate Risk Extremely High Risk

13. Would you argue that the budget hours for the audit of the sales cycle need to increase, remain the same, or be reduced, when compared with your revised budgeted hours in first year ?

Please tick (✓)
increase
remain
reduce

14. If you think that the hours budgeted should change, what figure would you argue for as the new budgeted hours for the audit of the sales cycle?

_____ hours

15. If you seek an increase for the number of hours required to audit the sales cycle would you recommend that your firm:

Please tick (✓)

- a) compensate by reducing the number of hours spent on other aspects of the audit
- b) seek an increase in the audit fee to cover the extra hours
- c) accept that the audit fee will not cover the increase in costs
- d) other, please specify _____

Please use this space for any additional comments on the issues addressed by this questionnaire. If needed, please use back of the page as well.

Would you like to receive a summary of the findings, when available? Please tick (✓)

Yes

No

This survey is confidential and neither your name nor your firm's name will be disclosed. If, however, you would be willing to participate in a follow-up interview once the results of the survey have been processed, please tick (✓)

Yes

No

If you have answered 'yes' for at least one of the above questions, please give your name, tel. no and contact address here:

THANK YOU FOR COMPLETING THIS QUESTIONNAIRE